

# Audit Report



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## COMMERCIAL SPARE PARTS PURCHASED ON A CORPORATE CONTRACT

Report No. 99-026

January 13, 1999

Office of the Inspector General  
Department of Defense  
Special Warning

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### **Acronyms**

DCMC	Defense Contract Management Command
DISC	Defense Industrial Supply Center
DLA	Defense Logistics Agency
DSCC	Defense Supply Center Columbus
DSCR	Defense Supply Center Richmond
DVD	Direct Vendor Delivery
FAR	Federal Acquisition Regulation
GPRA	Government Performance and Results Act
NSN	National Stock Number
PLT	Production Lead Time
POPS	Paperless Order Placement System



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202

January 13, 1999

MEMORANDUM FOR DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Audit Report on Commercial Spare Parts Purchased on a Corporate Contract  
(Report No. 99-026)

We are providing this redacted report for public release. This report is one in a series and is a follow-on to previous audits involving commercial pricing of spare parts.

DoD management comments on a draft of this report were considered in preparing the final report. The Director, Defense Logistics Agency comments were responsive and conformed to the requirements of DoD Directive 7650.3, therefore, no additional comments are required.

We provided the For Official Use Only version of the report to Allied Signal Incorporated for its comments on information that could be company confidential or proprietary. Allied comments were considered in preparing the redacted report for public release.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney at (703) 604-9288 (DSN 664-9288) or Mr. Henry F. Kleinknecht at (703) 604-9324 (DSN 664-9324). See Appendix E for the report distribution. A version of this report with protected information deleted is being prepared for release outside the Government. The audit team members are listed inside the back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the typed name.

Robert J. Lieberman  
Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

**Report No. 99-026**  
(Project No. 7CF-0058)

**January 13, 1999**

### **Commercial Spare Parts Purchased on a Corporate Contract**

#### **Executive Summary**

**Introduction.** This report is one in a series and is a follow-on to previous audits involving commercial pricing of spare parts. The first two reports covered Defense Hotline cases involving commercial pricing of spare parts. The first report discussed an allegation that the Defense Logistics Agency (DLA) paid a contractor significantly higher catalog prices for commercial items than the cost-based prices previously paid for the items. The second report discussed an allegation that DLA was procuring commercial and noncommercial items from another contractor on a sole-source basis. The sole-source prices were significantly higher than the competitive prices previously paid by DoD for the items. Since both allegations were substantiated, we conducted this audit to determine if DLA paid higher than fair and reasonable prices to other contractors.

During FYs 1996 and 1997, DLA issued delivery orders totaling \$25,389,275 to Allied Signal Incorporated (Allied) on corporate contract SP0500-96-D-9502 (the contract). We reviewed a total of 408 orders valued at \$20,521,536. The DLA supply centers used the contract to purchase spare parts that were commercial catalog items which included gearshafts, wheels, nuts, bearings, seals, filters, and valves. DoD buying offices also used eight additional contracts to procure items from Allied during FYs 1996 and 1997, however, none of the items purchased on those contracts were commercial items.

**Audit Objectives.** The primary audit objective was to determine whether commercial catalog prices paid by DoD to Allied were fair and reasonable when compared with previous noncommercial prices for the same items.

**Audit Results.** For the commercial purchases we reviewed, DLA supply centers paid Allied prices that were higher than fair and reasonable in FYs 1996 and 1997 when compared to the noncommercial prices paid to Allied in previous years. We determined that DLA paid a 54.5 percent premium for commercial parts from Allied. Included in the higher commercial prices were costs for Allied to manage, stock, and deliver the items directly to DoD users; which lowers the total ownership cost for the Government and allows DLA to take full advantage of Allied's commercial capabilities. In fact, effective implementation of the commercial buying practices and direct vendor delivery stipulated in contract SP0500-96-D-9502 would have helped offset the higher prices. Instead, DLA paid the premium, then purchased the parts for inventory and charged its customers the full cost recovery rates for inventory management and delivery of the items, thus

increasing its customers' costs by \$3.2 million for FYs 1996 and 1997. Proper application of acquisition reform principles could reduce total ownership cost by at least \$12.5 million for FYs 1999 through 2004. See Part I for details.

**Summary of Recommendations.** We recommend that the Director, DLA require the supply centers to break out spare parts when it provides the best value, procure items for stock when direct vendor delivery is not the best value and use other contracts when procuring these stock items, include only those parts on the contract that can be shipped directly from Allied to the user (direct vendor delivery), establish a test program to determine whether Allied can meet direct vendor delivery requirements, return excess commercial items in inventory, and instruct contracting officers not to place orders on the contract with delivery dates that exceed direct vendor delivery requirements. We also recommend that the Director require the supply centers to provide Allied with demand forecasting, coordinate commercial item technological improvements with the DoD acquisition team, establish metrics to monitor commercial prices and delivery, and charge the paperless order processing system non-stocked cost recovery rate to commercial spare parts purchased on the contract.

**Management Comments.** In response to the audit, DLA concurred with the recommendations and is taking actions to reduce total ownership costs for spare parts. DLA commented that the contract was one of the first prototypes and was launched before DLA established the procedural guidelines and protective mechanisms needed for this type of program. Although DLA did not have the procedures or training in place, it had believed that moving forward with the program was a better approach with the intention of developing the necessary guidance and procedures as the program evolved. DLA stated that the necessary guidance and procedures are now developed, or are in the process of being developed, and aggressive actions have been taken by renegotiating the prices of the parts and removing the delivery and price outliers. See Part I for a complete discussion of management comments and Part III for the full text of the comments.

**Audit Response.** Management comments were responsive. We acknowledge that the contract with Allied was a prototype for the direct vendor delivery program and believe that DLA has reacted constructively and aggressively to the problems identified by the audit. However, DLA and Allied must still demonstrate that the contract for commercial spare parts can work as intended. For the new acquisition reform contracts to be successful, DLA must establish equitable business relationships with its contractors using commercial business practices that lower product costs, reduce support infrastructure, and improve delivery. By implementing the recommendations in the report and establishing metrics to evaluate performance, DLA can determine whether the contract provides the intended acquisition reform measures and associated savings to its customers.

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## **Part I - Audit Results**

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## Introduction

This report is one in a series and is a follow-on to previous audits involving commercial pricing of spare parts. The first two reports covered Defense Hotline cases involving commercial pricing of spare parts. The first report discussed an allegation that the Defense Logistics Agency (DLA) paid a contractor significantly higher catalog prices for commercial items than the cost-based prices previously paid for the items. The second report discussed an allegation that DLA was procuring commercial and noncommercial items from another contractor on a sole-source basis. The sole-source prices were significantly higher than the competitive prices previously paid by DoD for the items. Both allegations were substantiated. This report is not Hotline related but was initiated because of the problems identified in the first two audits involving commercial pricing of spare parts.

During FYs 1996 and 1997, DLA issued 1,850 delivery orders totaling \$25,389,275 (177 orders over \$25,000 totaling \$20,060,964 and 1,673 orders under \$25,000 totaling \$5,328,311) to Allied Signal Incorporated (Allied) on corporate contract SP0500-96-D-9502 (the contract). We reviewed a total of 408 orders valued at \$20,521,536 (163 orders over \$25,000 totaling \$18,382,751 and 245 orders under \$25,000 totaling \$2,138,785). A total of 436 national stock numbers (NSNs) were procured on the 408 orders but some orders were for the same NSNs, consequently, there were 306 different NSNs. Our review focused on determining whether commercial prices were fair and reasonable for the 436 NSNs. The DLA supply centers used the contract to purchase commercial catalog items which included gearshafts, wheels, nuts, bearings, seals, filters, and valves. During FYs 1996 and 1997, DoD buying offices also used eight additional contracts to procure items from Allied; however, none of the items purchased on those contracts were commercial spare parts.

## Audit Background

**DLA Mission.** DLA is the central combat support agency that manages supplies in various commodity areas such as clothing, construction material, electronic supplies, fuel, food, general supplies, and medical supplies. DLA uses five supply centers to procure supplies.

- Defense Supply Center, Columbus, Ohio, (DSCC);
- Defense Energy Support Center, Fort Belvoir, Virginia;
- Defense Supply Center Richmond, Virginia, (DSCR);

- 
- Defense Industrial Supply Center, Philadelphia, Pennsylvania, (DISC);
  - Defense Supply Center, Philadelphia, Pennsylvania;

DLA supply centers consolidate the Services' requirements and procure the supplies in sufficient quantities to meet the Services' needs. Supplies are stored and distributed through a complex of depots or by direct vendor delivery (DVD). Consolidation of the distribution functions of the military Services and DLA depots was begun in 1990 and completed in March 1992, creating a single, unified supply distribution system managed by DLA. DLA also provides contract administration services through its Defense Contract Management Command (DCMC). DCMC has offices throughout the world located primarily at or near contractor plants. DCMC professionals provide preaward, post-award, and contract close-out services. The number of DLA civilian personnel has been reduced from 60,649 employees in FY 1993 to 44,307 in FY 1998 as part of the overall DoD downsizing.

**DLA Cost Recovery Rates.** DLA supply centers operate under a working capital fund concept and, therefore, charge their customers a cost recovery rate that is applied to the DLA acquisition cost of the items. The cost recovery rate includes costs to run the DLA supply centers and depots, overhead costs, and other material related costs such as inflation and transportation. The DLA cost recovery rate is then added to the DLA acquisition cost to establish the DLA sales price to DLA customers, generally the Military Departments.

Although the DLA supply centers have various cost recovery rates, there are primarily two different cost recovery rates, one for paperless order placement system (POPS) non-stocked items (commercial DVD items) and the other for non-POPS stocked items (items DLA procures for inventory). Accordingly, the cost recovery rates for the commercial DVD items were significantly less than the cost recovery rates for the items DLA procures for inventory.

**DLA Corporate Contracting Initiative.** DLA has started a corporate contracting initiative designed to adopt commercial business practices and provide benefits to its customers.

**DEFINITION:**

- o Adopts commercial business practices,
- o May include a vendor's full product line, or may aggregate requirements of one or more DLA Inventory Control Points,
- o Accesses commercial delivery/distribution systems (Direct Vendor Delivery),
- o Incorporates electronic data interface (EDI) ordering capability.

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**CUSTOMER BENEFITS:**

- o Lower product costs,
- o Ease of use,
- o Opportunity to reduce customer support infrastructure,
- o Improved delivery.

## **Audit Objectives**

The primary audit objective was to determine whether commercial catalog prices paid by DoD to Allied were fair and reasonable when compared with previous noncommercial prices. Although the audit announcement memorandum included an objective to review the management control programs at the various buying offices procuring items from Allied, DLA was the only buying office identified during the audit survey procuring commercial items from Allied. The adequacy of the DLA management control program was addressed in Inspector General, DoD, Report No. 98-088, therefore we did not review it further. See Appendix A for a discussion of the audit scope and methodology. Appendix B summarizes prior coverage related to the audit objectives.

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## Buying Commercial Spare Parts

Defense Logistics Agency supply centers paid higher prices for commercial spare parts on contract SP0500-96-D-9502 (the Allied corporate contract) when compared to previous noncommercial prices for the same items. The supply centers failed to effectively implement buying and inventory management practices designed to offset the higher commercial prices and take advantage of the contractor's capabilities. Specifically, the supply centers failed to:

- remove breakout items (items that could be procured from other than the original equipment manufacturer) and other Allied spare parts with significant price increases from the contract;
- determine whether delivery times published in the Allied commercial catalog were adequate to support DLA customer requirements and determine whether Allied could meet required delivery times;
- implement procedures to use direct vendor delivery, the chosen method of support for the contract, versus stocking items in defense depots; and
- implement procedures to provide Allied with reasonably accurate demand forecasting, coordinate proposed commercial item technological improvements with the DoD acquisition team, and establish metrics to monitor Allied's contract performance.

These failures occurred because DLA had not yet formulated good procurement and management strategies for commercial parts in the acquisition reform environment. As a result, DLA supply centers paid Allied commercial prices for spare parts which included costs for Allied to manage, stock, and deliver the items directly to DoD users (DLA customers). However, instead of taking advantage of these commercial services, the supply centers purchased large quantities of parts for inventory and applied their full cost recovery rates to manage, stock, and deliver the items to its customers. Duplication of costs to manage, stock, and deliver the items increased DLA customer costs by about \$3.2 million in FYs 1996 and 1997. Based only on the data reviewed for FY 1997, we calculate that DLA supply centers can reduce total ownership costs for their customers by at least \$12.5 million during FYs 1999 through 2004 if the Allied corporate contract is effectively implemented as intended.

## **Federal Regulations On Commercial Items**

**Market Research.** Policies and procedures for conducting market research to arrive at the most suitable approach to acquire, distribute, and support supplies and services are found in Federal Acquisition Regulation (FAR) Part 10, "Market Research." FAR 10.002, "Procedures," (d)(1) states:

If market research establishes that the Government's need may be met by a type of item or service customarily available in the commercial marketplace that would meet the definition of a commercial item at Subpart 2.1, the contracting officer shall solicit and award any resulting contract using the policies and procedures in Part 12.

**Acquisition of Commercial Items.** Policies and procedures unique to the acquisition of commercial items are found in FAR Part 12, "Acquisition of Commercial Items." It implements the Federal Government's preference for the acquisition of commercial items contained in Title VIII of the Federal Acquisition Streamlining Act of 1994 (Public Law 103-355) by establishing acquisition policies more closely resembling those of the commercial marketplace and encouraging the acquisition of commercial items and components.

Contracting officers are required to use the policies in FAR Part 12 in conjunction with the policies and procedures for solicitations, evaluation and award prescribed in Part 13, "Simplified Acquisition Procedures;" Part 14, "Sealed Bidding;" or Part 15, "Contracting by Negotiation;" as appropriate for the particular acquisition.

**Negotiating Prices for Supplies and Services.** Guidance and an order of preference for contracting officers in determining the type of information required when negotiating prices for supplies and services are found in FAR 15.402, "Pricing policy":

Contracting officers shall--

(a) Purchase supplies and services from responsible sources at fair and reasonable prices. In establishing the reasonableness of the offered prices, the contracting officer shall not obtain more information than is necessary. To the extent that cost or pricing data are not required by 15.403-4, the contracting officer shall generally use the following order of preference in determining the type of information required:

(1) No additional information from the offeror, if the price is based on adequate price competition, except as provided by 15.403-3(b).

(2) Information other than cost or pricing data:

(i) Information related to prices (e.g., established catalog or market prices or previous contract prices), relying first on

information available within the Government; second, on information obtained from sources other than the offeror; and, if necessary, on information obtained from the offeror. When obtaining information from the offeror is necessary, unless an exception under 15.403-1(b)(1) or (2) applies, such information submitted by the offeror shall include, at a minimum, appropriate information on the prices at which the same or similar items have been sold previously, adequate for evaluating the reasonableness of the price.

(ii) Cost information that does not meet the definition of cost or pricing data at 15.401.

(3) *Cost or pricing data.* The contracting officer should use every means available to ascertain whether a fair and reasonable price can be determined before requesting cost or pricing data. Contracting officers shall not require unnecessarily the submission of cost or pricing data, because it leads to increased proposal preparation costs, generally extends acquisition lead time, and consumes additional contractor and Government resources.

(b) Price each contract separately and independently and not--

(1) Use proposed price reductions under other contracts as an evaluation factor, or

(2) Consider losses or profits realized or anticipated under other contracts.

(c) Not include in a contract price any amount for a specified contingency to the extent that the contract provides for a price adjustment based upon the occurrence of that contingency.

## World Airlines and Supplier Guidance

The "World Airlines and Suppliers Guide," January 1994 (latest edition), establishes guidelines to enable suppliers to make a vital contribution to the continuance of a safe, efficient, and economically sound world air transport system (published by the Air Transport Association of America on behalf of its member airlines). The guide provides a single outline of policy against which all airlines and suppliers can operate.

Chapter 4 - "Inventory Policies," section 4-0-1 provides guidance on stocking items.

Suppliers are expected to maintain a shelf stock of items in repetitive use. Items in repetitive use are considered to be those for which two or more orders are received from one or more airlines within a twelve month period. Shelf stock may be negotiated for those unique parts

## **Buying Commercial Spare Parts**

(interior color-coded items) applicable to a single airline. Suppliers are also expected to stock high cost and/or long lead time items and insurance items.

Section 4-4-1 provides delivery time guidance.:

Suppliers are expected to deliver in accordance with quoted or published procurement lead times, and to also satisfy 7-4 and 7-6-1. Further, suppliers shall make every effort to ship AOG [aircraft on ground] material within 4 hours of request and to ship other critical material within 24 hours. Suppliers will provide relevant shipping information upon request. For these purposes, suppliers will need to operate 24 hours a day, 7 days a week.

Section 7-4-1 provides guidance on untimely deliveries.

To avoid unnecessary and untimely deliveries, airlines may call for material to be shipped on a specific date. This option may be exercised for any provisioning items. It may also be exercised for other items where the total extended order value is \$250 or more.

Section 7-6-1 provides guidance on expediting orders.

Airlines may require delivery of a new or existing order in less than the supplier's published or quoted lead time. After being advised in the expedite type, suppliers are expected to notify the airline of the action taken to satisfy the expedite as follows:

<b>Expedite Type</b>	<b>Supplier Response Time</b>
AOG (Aircraft on Ground)	Within 4 hours.
Critical (imminent AOG or work stoppage)	Within 24 hours
Expedite (less than published or quoted lead time)	Within 7 calendar days

In addition, Chapter 12, "Manufacturers' Technical Data," states that suppliers are expected to furnish technical data for their products in accordance with Air Transport Association of America Specification No. 100, "Manufacturers' Technical Data." Section 12-0-7 states "Suppliers are expected, on request, to furnish drawings for items which the airlines may wish to manufacture for their own use."

## Prices for Commercial Spare Parts

**Analysis of DoD Allied Commercial Prices.** For the items reviewed, DLA supply centers paid higher prices for commercial spare parts on the Allied corporate contract when compared to previous noncommercial prices for the same items. The supply centers then failed to effectively implement the intended buying and inventory management practices designed to offset the higher commercial prices. When only the price of the items was considered, DLA paid Allied "commercial" prices for spare parts that were \$5.5 million (54.5 percent) higher than previous DoD "noncommercial" prices for the same items. See Appendix A, methodology, for explanation of cost impact analysis.

Table 1 details commercial versus noncommercial prices. The supply centers began using the contract for commercial items in February 1996, comparative prices for noncommercial items were from orders placed any time between October 1, 1990 and prior to the issuance of the order for commercial items (except for those orders identified as "Old Data," prior to October 1, 1990).

**Table 1. DoD Allied Commercial Prices Were Higher Than Previous DoD Noncommercial Prices**

Basis for Price Reasonableness of Noncommercial Price	Number of NSNs	DoD Allied Commercial Prices		Noncommercial Prices		Total Price Increase	Percent Increase
		Total	Total (1998 dollars)	Total (1998 dollars)	Total		
Price Analysis	91	\$3,308,951	\$3,414,258	\$2,168,278	\$1,245,980	57.5	
Cost Based	68	3,917,463	4,043,213	2,836,071	1,207,142	42.6	
Breakout	43	844,945	870,151	545,921	324,230	59.4	
Surplus and Dealers	32	306,868	316,662	224,277	92,385	41.2	
Files not available	114	4,525,612	4,646,935	3,061,732	1,585,203	51.8	
Old Data (prior to Oct. 1, 1990)	70	2,325,453	2,381,992	1,306,870	1,075,122	82.3	
<b>Total</b>	<b>418</b>	<b>\$15,229,292</b>	<b>\$15,673,211</b>	<b>\$10,143,149</b>	<b>\$5,530,062</b>	<b>54.5</b>	

## Buying Commercial Spare Parts

When the data in Table 1 is sorted by fiscal year, the DoD Allied commercial items procured in FY 1997 show a higher percent increase (60.1 percent) than those procured in FY 1996 (45.8 percent). This 14.3 percent increase is cause for concern and could impact the reasonableness of the DoD Allied commercial prices and the method of support (DVD versus stock) if the trend continues. Market research performed by DCMC for corporate contract SPO700-98-D-9701 showed that many private companies made their purchase decisions based on forecasted demand and production lead time, similar to the Government (when purchasing items for stock not DVD). These companies purchased economic order quantities because the company's experience has been that the value of the inventory increased at a much higher rate than the cost of storage; namely, the value of the parts increases frequently at up to 10 percent annually, while the cost of stocking the parts is less than that.

Table 2 shows a higher percent increase for commercial items purchased in FY 1997 than commercial items purchased in FY 1996. This table reflects data from 70.4 percent of the total FY 1996 delivery orders and 55.3 percent of the total FY 1997 delivery orders.

**Table 2. DoD Allied Commercial Price Increases  
Were Higher In FY 1997 Than FY 1996**

Fiscal Year	Number of NSNs	DoD Allied Commercial Prices		Noncommercial Prices		Total Price Increase	Percent Increase
		Total	Total (1998 dollars)	Total	Total (1998 dollars)		
1996	154	\$5,548,193	\$5,777,922	\$3,961,604	\$3,961,604	\$1,816,318	45.8
1997	264	9,681,099	9,895,289	6,181,545	6,181,545	3,713,744	60.1
Total	418	\$15,229,292	\$15,673,211	\$10,143,149	\$10,143,149	\$5,530,062	54.5

## **Buying Practices for Commercial Spare Parts**

**Implementing Effective Buying Practices.** DSCC, DSCR, and DISC failed to effectively implement the intended buying practices for commercial spare parts on the contract with Allied. Although the intent of the contract was appropriate, the intended buying and inventory management practices were not implemented because the supply centers failed to:

- remove breakout items and other Allied spare parts with significant price increases from the contract;
- determine whether the contract delivery times would support customer requirements without stocking items;
- implement procedures to use direct vendor delivery (DVD); and
- provide Allied with reasonably accurate demand forecasting, coordinate proposed commercial product improvements with the item managers, users, and engineering support activities, and establish metrics to monitor Allied's performance on the contract.

**Intended Use of the Contract.** DISC was the supply center responsible for awarding the contract which was designed to include only those items that were "sole source" to Allied. The contract prices were negotiated with Allied at a discount from the Allied commercial catalog (DoD Allied commercial prices). As part of the justification for the contract, DISC included production lead-time savings (PLT) associated with Allied maintaining and distributing inventory. Reducing PLT generates cost savings by allowing DoD to carry less inventory. It was intended that 95 percent of the contract would be implemented using DVD procedures so that the parts would be shipped directly from Allied to the DLA customers (or users). DISC calculated that this PLT/DVD savings ranged from 20 to 40 percent of the item acquisition cost. Allied calculated the minimum PLT/DVD saving to be [REDACTED] percent of the acquisition cost (Appendix C). The PLT/DVD savings were a major factor in the DISC contracting officer's determination that the contract constituted a best value to the Government when price, quality, and delivery were considered. Both Allied and DLA determined that the trade-off in paying higher catalog prices was justified by lower costs to manage, stock, and deliver the parts. In addition, two of the DoD Functional Area Reform Goals determined in the Government Performance and Results Act (GPRA) are reducing average order to receipt time by 50 percent and reducing supply inventory by \$12 billion. The contract with Allied, properly executed, would help achieve these reform goals.

## Breakout Items and Prices for Other Allied Spare Parts

**Spare Parts Breakout.** Although the contract was intended only for the purchase of sole-source Allied spare parts (parts that Allied controls the technical data rights to), the supply centers used the contract to procure items that could have been procured from the actual manufacturers at lower prices. Table 1 shows 43 of the 418 NSNs reviewed that are not sole-source Allied parts and which can be procured from the actual manufacturers at significantly lower prices. DLA supply centers need to determine which items on the contract are not sole-source Allied parts and procure those items from the actual manufacturers when that is determined to be the best value for DoD and its customers.

During the audit, DISC took corrective action to remove breakout items from the contract. (These items are not included in Table 1.) Although these items are being stocked by DLA, the savings associated with procuring the parts from the actual manufacturers and stocking them appears to be the best value for DoD and DLA customers.

Table 3 shows parts that DISC procured from Allied on the contract; items that before the contract were, and are again, being procured from the actual manufacturers at significantly lower prices. For the 10 different NSNs, DISC saved 141 percent by breaking out the items and purchasing them from the actual manufacturers.

**Table 3. Actions Taken by DISC to Return to Breakout**

NSNs	Breakout Quantity	Breakout Price (1998 dollars)		1998 Allied DoD Commercial Price		Difference	
		Unit	Total	Unit	Total	Total Dollar	Percent
	560	\$59.19	\$33,146	\$251.69	\$140,946	\$107,800	325.2
	130	63.89	8,306	251.69	32,720	24,414	293.9
	79	783.82	61,922	956.30	75,548	13,626	22.0
	300	52.80	15,840	79.65	23,895	8,055	50.9
	1,000	19.58	19,580	47.30	47,300	27,720	141.6
	225	187.79	42,253	280.13	63,029	20,777	49.2
	358	122.47	43,844	166.87	59,739	15,895	36.3
	500	48.81	24,405	350.30	175,150	150,745	617.7
	250	81.82	20,455	238.05	59,513	39,058	190.9
	1,150	16.15	18,573	23.20	26,680	8,108	43.7
	225	100.02	22,505	197.55	44,449	21,944	97.5
<b>Total</b>			<b>\$310,829</b>		<b>\$748,969</b>	<b>\$438,142</b>	<b>141.0</b>

**Allied Commercial Price Concessions.** During the audit DSCR obtained price concessions for three NSNs on the contract where the reasonableness of the commercial price was questioned (see Table 4).

For NSN [REDACTED], DSCR obtained the price concession based on price analysis. The price concessions for the other two NSNs were based on cost analysis of information other than cost or pricing data provided by Allied. Although the price concession ([REDACTED] percent) for the first part warrants removing the part from the contract and using another contract vehicle to procure and stock the item; it is questionable whether the price concessions for the other two parts sufficiently offset PLT/DVD savings associated with the contract, and warrant buying and stocking the items. DLA supply centers need to determine which

Allied parts should be procured on the contract and which parts should be procured for stock on another contract vehicle based on the best value to DoD and DLA customers.

Table 4 shows the price concessions DSCR obtained for three parts on the contract.

**Table 4. Price Concessions Obtained By DSCR Varied for Different Parts**

NSN (2835-)	Order		DoD Allied Commercial Price		Allied Price Concessions		Difference	
	No.	Qty	Unit	Total	Unit	Total	Dollar	Percent*
	Z151	98	\$2,846.25	\$278,933	\$782.33	\$76,668	\$202,265	263.8
	Z192	205	2,846.25	583,481	782.60	160,433	423,048	263.7
	Z167	65	16,290.00	1,058,850	12,032.00	782,080	276,770	35.4
	Z171	57	16,290.00	928,530	12,032.00	685,824	242,706	35.4
	Z155	122	8,931.60	1,089,655	6,350.00	774,700	314,955	40.7
	Z221	360	8,931.60	3,215,376	6,350.00	2,286,000	929,376	40.7
<b>Total</b>				<b>\$7,154,825</b>		<b>\$4,765,705</b>	<b>\$2,389,120</b>	<b>50.1</b>

\*Represents the percent by which the commercial price is higher than the price concession.

## Commercial Catalog Delivery Times

**Method of Support.** DLA supply centers did not determine whether the delivery times published in the Allied commercial catalog would support customer requirements when using DVD as the method of support. DISC awarded the corporate contract with an agreement that Allied would deliver items within the published catalog delivery time allowing an additional three days for receipt. However, the published delivery times in the catalog fluctuated from year to year and often were not adequate to support DVD requirements for private industry and DLA.

The World Airlines and Suppliers Guide provides commercial standards for suppliers on stocking and delivering commercial items. These commercial standards provide for supplier response within 4 hours for aircraft on the ground to normal supplier published or quoted leadtimes. DLA guidance provides that regardless of price, the contractor must be able to supply the customer with the item in the same amount of time that the depots supply the customer to maintain

military readiness. According to DLA personnel, the Defense depot system has a delivery time average of 20 days. In a July 20, 1993 memorandum to the DLA supply centers, the DLA Deputy Director, Material Management stated:

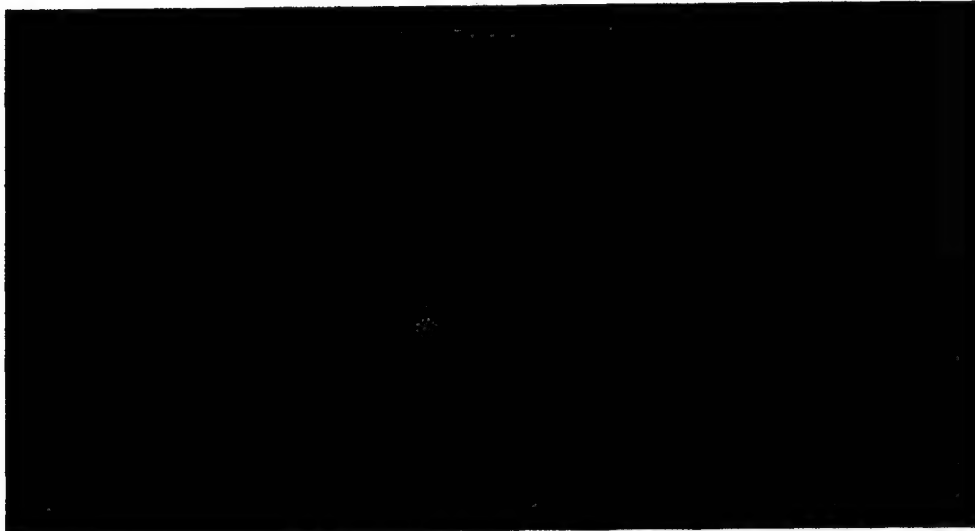
We want long term contracts that are mostly DVD, with maximum use of the commercial distribution systems. A major part of the planning inherent in pursuing this approach has to address our ability to rapidly respond to warfighter needs particularly for critical items. For this reason we will never be able to eliminate all of our inventory because for many items industry cannot provide the readiness and sustainability our customers require. However, where industry can provide us response equal to or better than the Defense depot system, DVD is the preferred alternative.

**Changes in Catalog Delivery Times.** Delivery times published in the Allied catalog changed dramatically from year to year and for a significant number of the items procured by DLA supply centers the published delivery times were in excess of 20 days, thereby reducing the possibility that Allied would provide delivery equal to, or better than, the Defense depot system.

Appendix D, "Allied Catalog Days to Delivery," shows dramatic fluctuations in Allied published catalog delivery times for the same items in 1996, 1997, and 1998. Although the 1998 Allied commercial catalog shows a delivery time within 20 days for most of the parts reviewed, the 1996 and 1997 Allied commercial catalogs did not. DLA supply centers, in conjunction with Allied, need to determine which parts in the catalog can be supplied within 20 days (or the time necessary to meet DVD requirements) regardless of the delivery time published in the catalog, and include only these parts on the contract. Parts that Allied cannot deliver within the time necessary to satisfy DVD requirements should be procured for inventory using a different contract.

**Meeting Required DVD Delivery Times.** Allied has not demonstrated that it can meet either the delivery times specified in its catalog or the times required for DVD. In fact, Allied only made the first delivery within 20 days for ■ of the ■ items (about ■ percent of the time). Allied representatives stated required delivery times could not be met because DLA was ordering large quantities of spare parts for stock. Typically, under DVD practices the buyer procures small quantities of items on a "just in time" basis as items are needed. Allied delivered about ■ percent (mean) and ■ percent (median) of items on first delivery.

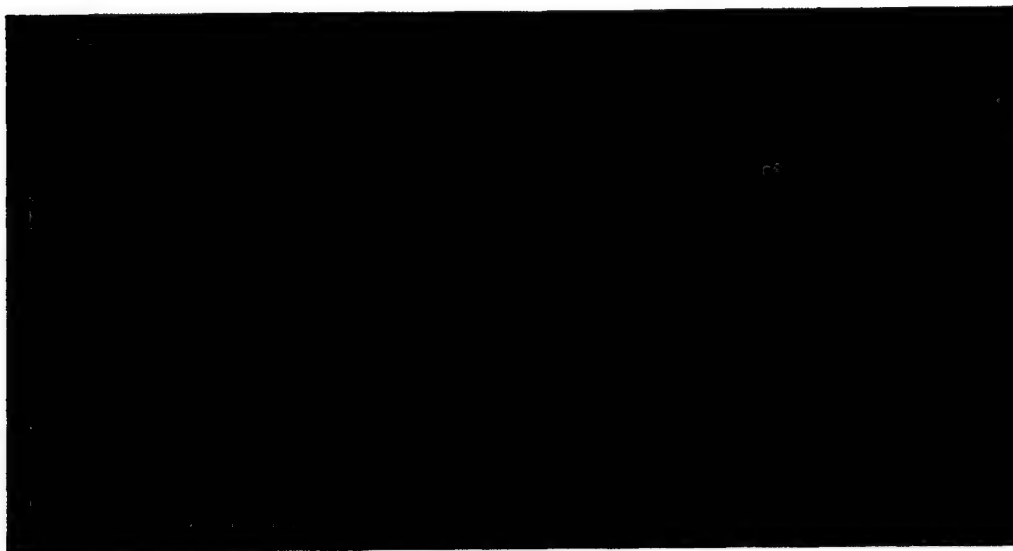
Figure 1 shows that Allied delivered ■ items, about ■ percent (first delivery) within 20 days.



**Figure 1. Days for Allied to Make First Delivery of Commercial Catalog Items.**

Since Allied's catalog prices were based upon delivering the items to DLA customers "just in time," DoD was not receiving all it paid for. DLA supply centers need to establish a test program with Allied to determine whether required delivery times for DVD can be met. This test program should determine whether Allied can meet commercial and contract standards for delivery such as "aircraft on ground" (4 hours) and "critical" (24 hours).

Figure 2 shows the number of days for final delivery when partial shipments were delivered. The failure to meet industry and DLA standards for DVD delivery of these items clearly does not justify paying the premium commercial price to Allied.



**Figure 2. Days for Allied to Make Last Delivery of Commercial Catalog Items.**

## Procedures for Direct Vendor Delivery

**DLA Supply Centers failed to Implement DVD Procedures.** Although the contract was intended to provide direct delivery of supplies from Allied to DLA customers; DLA supply centers failed to implement procedures to use direct vendor delivery. Instead DLA procured items for its inventory and stocked the Defense depots. Further, the items were not loaded into the Paperless Order Placement System (POPS) required for DVD for various reasons including the fact that delivery times published in the Allied catalog often did not meet the DoD delivery requirements for DVD.

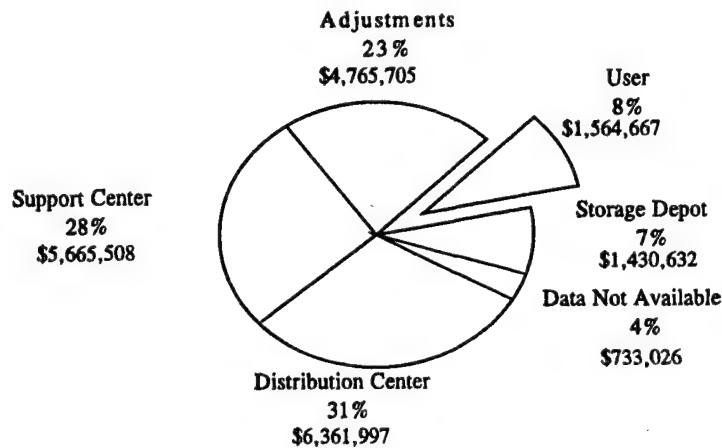
**Paperless Order Placement System.** POPS is an electronic interface, using Electronic Commerce/Electronic Data Interchange, between the DLA supply centers and the commercial industry to enable the supply centers to fill customer requisitions for commercial items quickly and effectively direct from the vendor-maintained inventory to the customer. POPS is the primary tool DLA uses for direct vendor delivery and POPS also provides a mechanism for DLA to apply the appropriate cost recovery rates to commercial items procured via DVD. If an item

on a DVD contract is not classified as POPS and the delivery order specifies a DLA depot for the delivery location, DLA assesses a higher cost recovery rate for the item.

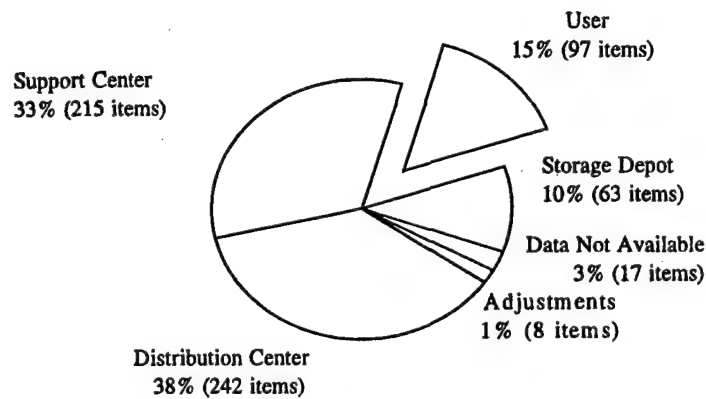
**Commercial Spare Parts Purchased for Inventory.** Only 8 percent of the 408 orders based on dollar value or 15 percent of the 642 contract line items (408 orders) were delivered directly to DoD users as intended for the contract. Most of the items purchased were delivered to the three types of depot operations managed by DLA.

DLA uses three distinct types of distribution depot operations - distribution centers, support centers, and the storage depots. The distribution centers are high-volume, mechanized distribution facilities which are specifically designed to provide world-wide support for general commodities. The two major distribution centers include the east coast region-Susquehanna, Pennsylvania and the west coast region- San Joaquin, California. There are also support centers which provide support to local customer requirements and global support for materials with specific item characteristics that require special handling or unique storage requirements. Finally, there are storage depots which are facilities designated as wholesale storage sites for specific commodities and/or low activity items with poorly defined demand patterns.

Figure 3 shows that only 8 percent of the 408 orders, based on dollar value, were shipped DVD to the users. The 8 percent represents items that were purchased through POPS or items that were designated with a priority code. The remaining items were purchased through the normal acquisition process and were specified to be delivered directly to the depots. The 23 percent for adjustments reflects those items on which DSCR received price concessions from Allied (Table 4). Those items were purchased for stock and correctly delivered to the depots. We were unable to determine the delivery destinations for 4 percent of the orders due to insufficient data. (Figures 3 and 4 were based on delivery information for 642 contract line items on the 408 delivery orders, some orders had multiple contract line items for different NSNs and for the same NSNs shipped to different locations.)



**Figure 3. Commercial Spare Parts Shipped to DLA Inventory (dollars).**



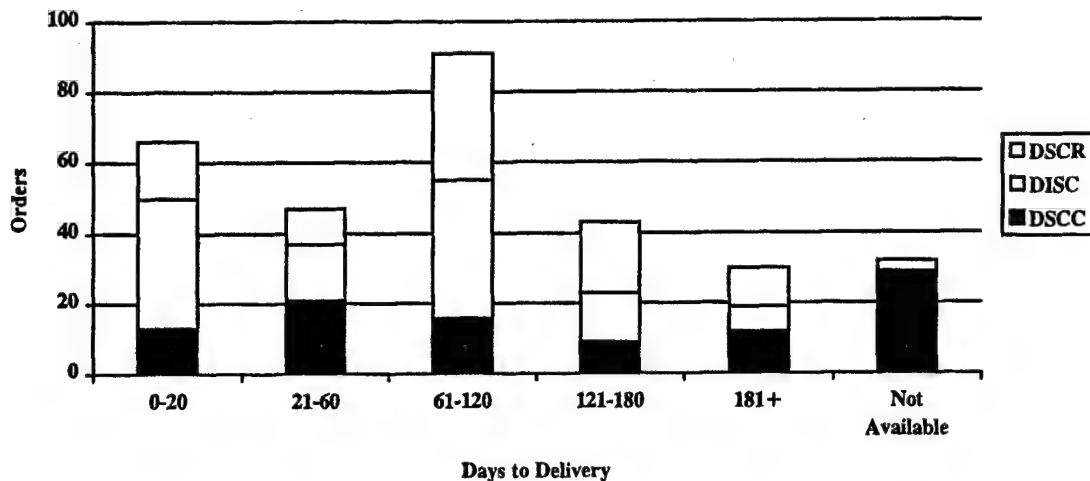
**Figure 4. Commercial Spare Parts Shipped to DLA Inventory (number of contract line items).**

DLA supply centers need to determine what commercial spare parts are currently in DLA depots at levels that exceed current known requirements and if feasible, initiate action to return these commercial items to Allied.

**Order Delivery Times.** DLA contracting officers issued delivery orders against the contract with scheduled delivery dates that did not meet DVD requirements. For 324 of the 408 orders reviewed with scheduled delivery dates (delivery dates were not available on POPS orders), DLA originally scheduled delivery within 20

days from the order date on only 96 of the orders (about 31 percent). DLA later modified the delivery date (as provided for in the contract) on 30 of the 96 orders beyond the 20 day period.

Figure 5 shows the required delivery times on orders placed by DLA contracting officers were much longer than the 20 days required to achieve the necessary PLT/DVD savings needed to justify the contract.



**Figure 5. Scheduled Delivery Dates Were Not Adequate to Support PLT/DVD Requirements.**

Whenever contracting officers extend delivery times beyond the times specified in the contract, DLA is paying for services it is not going to receive. DLA contracting officers should not place orders on the contract with delivery dates that exceed 20 days or minimum DVD requirements.

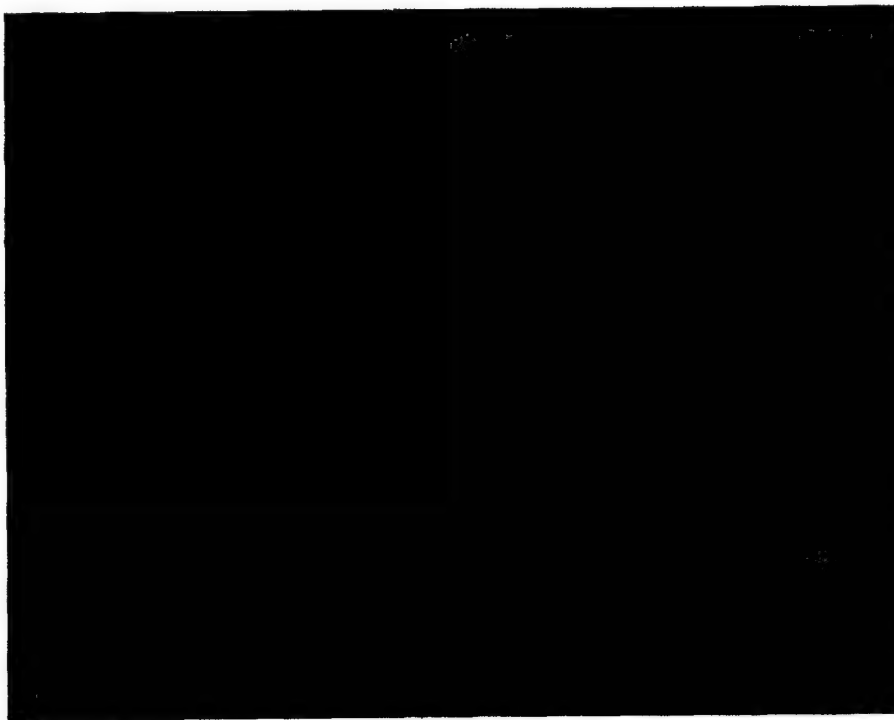
## Demand Forecasting, Product Improvement, and Metrics to Monitor Performance

**Demand Forecasting.** DLA supply centers have not provided Allied with reasonably accurate demand forecasting. During FYs 1996, 1997 and the first half of 1998 DLA met twice with Allied to provide demand forecasting information. However, the information provided to Allied was more of a general nature and not the specific information on parts usage required for effective demand forecasting. In addition, the information provided was mainly procurement history instead of information on future user requirements. As a result, Allied frequently did not have sufficient stock of the items for which DLA

was the primary customer. Allied uses requirement forecasting as a tool to anticipate customer needs and help determine what items/quantities to stock. As with any commercial company, the goal is to turn over inventory as frequently as possible. Without accurate demand forecasting, Allied must either incur significantly more risk and stock excessive items that are primarily DoD-specific, or not comply with catalog delivery times because of inadequate supplies in stock.

We reviewed commercial sales data from Allied during calendar years 1995 through the first two months of 1998 for [REDACTED] of the [REDACTED] different NSNs reviewed. The data showed that for about half of the parts [REDACTED], DLA was purchasing less than [REDACTED] percent of Allied's total sales.

Figure 6 shows that although DLA was the primary customer for a large number of the commercial items, [REDACTED] percent or less of the commercial sales were to the Government for about half of the items.



**Figure 6. For About Half of the Items, [REDACTED] or Less of the Commercial Sales Were to the Government.**

Using the commercial spare parts of which Allied has significant sales to the commercial marketplace appears to be a good starting point for Allied to demonstrate that it can satisfy DLA delivery requirements because the parts are known to be in the Allied commercial supply system. DLA also needs to

establish procedures to provide Allied with reasonably accurate demand forecasting, especially for those parts not used extensively in the commercial marketplace.

**Coordinate Commercial Product Improvements.** DLA supply centers have failed to adequately coordinate commercial product improvements with the DoD acquisition team (contracting officers, item managers, users, and engineering support activities). For example, Allied told us that NSNs [REDACTED] (turbine wheel), and [REDACTED] and [REDACTED] (nozzles) have been upgraded to the latest technology material that can withstand higher temperatures for longer periods of time. Conservative estimates forecast a two-to-one increase in "time on wing" (service life) for this new technology. However, although DLA is purchasing the nozzles made of the new material, the turbine wheels made of the old, less-efficient materials, are still being purchased. In addition, Allied told us that when these parts are replaced at Air Force bases, the old parts are either discarded or sold for salvage. In most cases these are repairable parts that can be reworked. In the commercial marketplace airlines have these parts reworked before buying new ones. The rework prices are significantly lower than the prices for new parts. DLA supply centers need to implement procedures to provide information on proposed contractor technology improvements to the DoD acquisition team for evaluation in order for the team to make the best value decisions.

**Metric to Evaluate Commercial Price Increases.** DLA needs to establish a metric to monitor price increases for commercial spare parts. The metric should measure the contractor price increases on an annual basis to ensure that increases are in line with the rate of inflation and the commercial market. For example, if the commercial market expanded to eliminate sole-source contractors and produced better competitive prices for the same or similar items then the price increases should be comparable to those of the commercial market. In addition, the metric should also measure whether the price increases are warranted based upon the past performance of the contractor. For example, if past performance shows that the contractor failed to meet the delivery time requirements of its customers, then the increase in price should be compatible with the capability of the contractor. If the price increases are out of line with inflation, commercial market, or past performance; then DLA needs to take corrective action to ensure that its customers get the best value for their money. If annual commercial price increases are greater than the costs to stock the parts, DLA must reconsider procuring economic order quantities and stocking the items.

For a market basket of items that DLA purchased from the Allied commercial catalog and which were in each year's catalog (225 of the 306 NSNs reviewed), we calculated that the [REDACTED]

[REDACTED] over the past two years. Although the terms and conditions of the corporate contract stipulate that Allied can incorporate an annual 25 percent economic price adjustment to its catalog prices, the increase in prices must be in keeping with current economic conditions and with the rate of inflation in order to maintain price reasonableness. DLA supply centers need to

establish a metric to monitor and control the reasonableness of these price increases, particularly when there is no competitive commercial market to ensure price integrity. For example, we found that Allied increased its catalog price for a valve diaphragm by ■ percent from 1996 to 1997. We also found that the catalog price increased ■ percent for a turbine wheel seal from 1997 to 1998 while the price decreased by ■ percent for the same item in the previous year.

Table 5 shows the commercial catalog price increases in 1997 and 1998.

<b>Table 5. Allied Signal Commercial Catalog Prices</b>							
<u>Centers</u>	<u>Total Catalog Prices</u>			<u>Total Price Increase</u>		<u>Percent Increase</u>	
	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1997</u>	<u>1998</u>	<u>1997</u>	<u>1998</u>
DSCC	4,071,000	4,371,790	4,648,546	300,790	276,756	7.4	6.3
DISC	2,211,025	2,329,336	2,455,322	118,312	125,985	5.4	5.4
DSCR	11,657,329	12,411,326	13,124,213	753,996	712,887	6.5	5.7
<b>Total</b>	<b>\$17,939,354</b>	<b>\$19,112,452</b>	<b>\$20,228,081</b>	<b>\$1,173,098</b>	<b>\$1,115,628</b>	<b>6.5</b>	<b>5.8</b>

**Metrics to Monitor Delivery Performance.** DLA also needs to establish a metric to monitor Allied's performance meeting corporate contract delivery times needed to provide DVD service to its customers. The metric should measure the lead time required for an item to be delivered based upon the ability of the contractor, the location of the delivery, and whether the item has any special handling or storage requirements. For comparison purposes, the metric should also measure the capability of the depots to meet these delivery requirements and whether the contractor can meet or beat the delivery times of the depots. If the contractor fails to meet the delivery requirements of its customers based upon the outcome of the metric, DLA needs to take appropriate action to ensure that those requirements can be met.

## Reducing Total Ownership Costs

**Duplicating Costs to Manage, Stock and Deliver Spare Parts.** The commercial prices DLA supply centers paid Allied for spare parts included the costs for Allied to manage, stock, and deliver the items directly to the users. The supply centers then purchased the parts for inventory and applied their full cost recovery rates to manage, stock, and deliver the items to their customers. Duplicating costs to manage, stock, and deliver the items increased DLA customer costs by about

\$3.2 million in FYs 1996 and 1997. Based only on the data reviewed for FY 1997, we calculate that DLA supply centers can reduce total ownership costs for their customers by at least \$12.5 million (\$2,075,737 [Table 6] x 6 years = \$12,454,422), if DLA implements the contract as intended.

Table 6 shows that the DLA supply centers charged their non-POPS stocked cost recovery rate to \$13.9 million of commercial spare parts purchased on the contract. Had the commercial spare parts been managed as intended (DVD), DLA could have saved its customers over \$3.2 million by applying its POPS non-stocked cost recovery rate. DLA did correctly charge their POPS non-stocked cost recovery rate to about \$1.4 million (67 NSNs) of commercial spare parts on the contract.

**Table 6. Using the POPS Direct Vendor Delivery Cost Recovery Rate Will Significantly Lower Customer Total Ownership Costs for Commercial Items**

Supply Center	Number of NSNs	DLA Acquisition Cost	Non-POPS Stocked		POPS DVD		Difference
			Cost Recovery Rate (percent)	Total Customer Price	Cost Recovery Rate (percent)	Total Customer Price	
FY 1996							
DSCR	40	\$ 2,820,400	31.2	\$ 3,699,510	7.4	\$ 3,029,110	\$ 670,400
DSCC	37	862,635	35.5	1,168,781	18.0	1,017,909	150,872
DISC	57	1,064,171	34.2	1,427,231	10.3	1,173,781	253,450
Subtotal	134	\$ 4,747,206		\$ 6,295,522		\$ 5,220,800	\$1,074,722
FY 1997							
DSCR	63	4,968,472	32.9	6,601,976	7.6	5,346,076	1,255,900
DSCC	83	3,379,273	35.6	4,582,062	18.0	3,987,542	594,520
DISC	71	852,525	36.8	1,165,652	10.3	940,335	225,317
Subtotal	217	\$ 9,200,270		\$12,349,690		\$10,273,953	\$2,075,737
Total	351	\$13,947,476		\$18,645,212		\$15,494,753	\$3,150,459

Although the cost recovery rates DLA supply centers charged their customers were appropriate for the manner in which DLA managed the commercial items, the rates were not appropriate for the manner in which the contract was supposed to be used. Another area of concern is the significant difference between POPS

non-stocked cost recovery rates at the DLA supply centers, ranging from 7.6 to 18 percent. In comparison, the General Services Administration charges its customers a one percent industrial funding fee for all orders placed under multiple award schedule contracts. The one percent fee covers the spectrum of administrative costs to manage the program from market research, procurement planning, solicitation issuance, evaluation of proposals, negotiation and award, contract administration, marketing publications, etc.

If DLA wants to procure commercial items from Allied, the POPS non-stocked cost recovery rates must be used.

### **Summary**

Congress enacted acquisition reform legislation to improve access to commercial technologies, reduce administrative overhead, and reverse the trend toward over regulation. As indicated by the results of this audit, the DoD acquisition team and Allied were still learning how to establish equitable business relationships in the acquisition reform environment. In this particular case, the DLA acquisition team was not sufficiently aggressive in effectively implementing the contract with Allied to obtain the PLT/DVD savings intended for the commercial spare parts. When savings associated with PLT/DVD (20-40 percent used by DISC or 33.5 percent used by Allied) are factored into the commercial prices, the corporate contract prices become more in keeping with previous prices. If breakout items and about 10 percent of the Allied commercial items (38 orders) that showed significant price increases were removed from the corporate contract, prices for the majority of the items on the corporate contract would be in-keeping with previous prices. Consequently, if DLA and Allied can make the contract work as intended and control commercial price increases, the contract may provide an effective vehicle for DoD to procure commercial spare parts and achieve the related GPRA DoD Functional Area Reform Goals. Conversely, if this cannot be accomplished, DLA and its customers will continue to pay excessive prices.

DLA has reacted constructively and aggressively to the problems found by the audit (breakout and price concessions Tables 3 and 4); however, DLA and Allied must still demonstrate that they can make the contract for commercial spare parts work as intended. Otherwise, DLA will need to revert back to the previous buying practice of negotiating better prices for the spare parts and procuring economic order quantities for inventory.

## **Management Comments on the Finding and Audit Response**

**Management Comments on Cost Avoidance Savings.** DLA commented that since the contract had been reduced to 790 items due to removal of price and delivery outliers, the five-year cost avoidance savings may need updating.

**Audit Response.** The six-year cost avoidance savings of \$12.5 million was based only on the 217 NSNs reviewed in FY 1997; therefore, we believe the calculation to be conservative when compared to the overall number of items on the contract.

**Management Comments on Spare Parts Breakout.** DLA commented that some of the suppliers for the parts in question were not actual manufacturers but dealers, including non-stocking parts locators and suppliers of surplus parts. DLA commented that the system misidentified a non-manufacturing source as a manufacturer and that the items were coded as noncompetitive at the time the orders were placed under the corporate contract.

**Audit Response.** After further review we determined that 3 of the 46 NSNs identified as "Breakout" in Table 1 were actually procured from "Surplus and Dealers." The table was corrected accordingly.

**Management Comments on Direct Vendor Delivery Procedures.** The Defense Logistics Agency commented that the Inventory Control Points took appropriate action by not utilizing the POPS DVD since the contractor could not meet the customer's delivery requirements.

**Audit Response.** The use of POPS is essential for DVD since it enables the supply centers to fill customer requisitions for commercial items quickly and effectively direct from the vendor-maintained inventory to the customer through electronic data interchange. POPS also utilizes the lower DLA supply center cost recovery rates. If unable to use POPS, the contract would not provide the best value for DLA or its customers.

**Management Comments on a Metric to Evaluate Commercial Price Increases.** DLA commented that knowledge of the price trend for competitive commercial items is important and that the Government has leverage for these items through published market prices. However, DLA believes that it has minimal leverage for noncompetitive commercial items acquired from sole-source suppliers.

**Audit Response.** The establishment of a metric to monitor commercial price increases is an essential tool in evaluating price increases and can also be used as a bargaining device in negotiations regardless of whether an item is procured competitively or noncompetitively. Although we agree that the Government has less leverage when procuring from a sole-source supplier, the contracting officer must be assertive in negotiating a best-value contract for the Government. In

addition, if adequate metrics are developed and used properly they can provide the contracting officer more leverage in negotiating better prices and controlling price increases for these commercial spare parts.

**Management Comments on POPS Cost Recovery Rates.** The Defense Logistics Agency commented that the POPS cost recovery rates for FYs 1998 and 1999 were 7.4 and 7.0 percent, respectively. DLA also commented that the comparison of DLA's cost recovery rate against GSA's rate is invalid without analyzing the different funding streams and customer services of the two Government agencies.

**Audit Response.** We commend DLA for its efforts in lowering POPS cost recovery rates for FYs 1998 and 1999. However, we used the POPS cost recovery rate of 7.6 percent applicable to our audit scope for FYs 1996 and 1997.

During our audit, DLA supply centers assessed a POPS DVD cost recovery rate ranging from 7.6 to 18 percent while GSA charged its customer a one percent industrial fee. We acknowledge that there are differences in the customer service costs and operational infrastructure for the different agencies as there are within the different DLA supply centers.

**Management Comments on the Removal of the Breakout Items.** DLA commented that they have taken aggressive action by eliminating all but three of the breakout items and all of the price and delivery outliers. As a result of these actions, DLA has demonstrated that it can make the contract for commercial spare parts work as intended.

**Audit Response.** We commend DLA for its effort in eliminating the breakout items and the price and delivery outliers from the corporate contract to become more in keeping with previous prices. However, we do not believe that the mere removal of these items demonstrates that the corporate contract is working as intended. Other issues concerning timely deliveries, direct vendor delivery, and appropriate cost recovery rates need to be resolved and monitored with the appropriate metrics before the corporate contract can be classified as a success.

## **Recommendations, Management Comments, and Audit Response**

**We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to:**

- 1. Determine which items on the contract are not Allied sole source items and procure those items directly from the actual manufacturers when that is determined to be the best value for DoD and its customers.**

**2. Determine which Allied parts should be procured on the corporate contract and which parts should be procured for stock on another contract based on the best value to DoD and Defense Logistics Agency customers.**

**3. In conjunction with Allied, determine which parts in the catalog can be supplied within 20 days (or the time necessary to meet direct vendor delivery requirements) regardless of the delivery time published in the catalog, and include only those parts on the contract.**

**4. Procure and inventory parts using a different contract when Allied cannot deliver items within the time necessary to satisfy direct vendor delivery requirements.**

**5. Establish a test program with Allied to determine whether required delivery times for direct vendor delivery can be met. This test program should also determine whether Allied can meet commercial and contract urgent requirements for items such as "aircraft on ground" (4 hours) and "critical" (24 hours).**

**6. Determine what commercial spare parts are currently in Defense Logistics Agency depots at levels that exceed current known requirements and, if feasible, initiate action to return these commercial items to Allied for future credit.**

**7. Instruct contracting officers not to place orders for commercial spare parts on the contract with delivery dates that exceed 20 days or minimum direct vendor delivery requirements.**

**8. Establish procedures to provide Allied with reasonably accurate demand forecasting, especially for those parts not commonly used in the commercial marketplace**

**9. Implement procedures to provide information on proposed contractor technology improvements to the DoD acquisition team for evaluation in order for the team to make the best value decisions.**

**10. Establish a metric to monitor commercial catalog price trends in all DLA corporate contracts.**

**11. Establish a metric to measure whether price increases for commercial items are warranted based upon past performance.**

**12. Establish a metric to monitor Allied's performance on meeting commercial item delivery times needed to provide direct vendor delivery service to its customers.**

**13. Evaluate the cost recovery rates to ensure reasonableness and that separate rates are justified among centers, then charge the paperless order placement system non-stocked cost recovery rate to commercial spare parts purchased on the contract.**

**Management Comments.** DLA fully concurred with all recommendations except Recommendation 7 which was partially concurred with. DLA stated that the necessary guidance and procedures are now developed, or are in the process of being developed, for the contract to work as intended. Therefore, the associated "best value" savings originally planned under the contract should pass to DLA and its customers.

**Audit Response.** DLA comments are fully responsive including its comments to Recommendation 7. We believe that the DLA has reacted constructively and aggressively to the problems found by the audit. However, DLA and the contractor must still demonstrate that the contract for commercial spare parts can work as intended. By implementing the recommendations and recommended metrics to evaluate contractor performance, DLA can determine whether the contract provides the intended acquisition reform measures and associated savings to DLA and its customers.

## **Part II - Additional Information**

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## Appendix A. Audit Process

### Scope

**Work Performed.** We reviewed DLA procedures and support contract documentation for delivery orders issued by DSCC, DSCR, and DISC to Allied under contract SPO500-96-D-9502. During FYs 1996 and 1997, DLA issued 1,850 delivery orders totaling \$25,389,275 (177 orders over \$25,000 totaling \$20,060,964 and 1,673 orders under \$25,000 totaling \$5,328,311) to Allied Signal Incorporated (Allied) on corporate contract SP0500-96-D-9502 (the contract). We reviewed a total of 408 orders valued at \$20,521,536 (163 orders over \$25,000 totaling \$18,382,751 and 245 orders under \$25,000 totaling \$2,138,785). A total of 436 NSNs were procured on the 408 orders, there were 306 different NSNs ordered. Our review focused on determining whether commercial prices were fair and reasonable for the 436 NSNs. We also reviewed comparison buys of the same parts on other contracts. We reviewed Allied sales information for commercial items for calendar years 1995 through the first quarter 1998. Appendix D and Figures 1 and 2 reflect delivery information for 309 of the 436 NSNs reviewed. Other items in the scope had not been delivered or delivery data was deemed unreliable.

**DoD-wide Corporate Level Government Performance and Results Act (GPRA) Goals.** In response to the GPRA, the Department of Defense has established 6 DoD-wide corporate level performance objectives and 14 goals for meeting these objectives. This report pertains to achievement of the following objectives and goals.

- **Objective:** Fundamentally reengineer the Department and achieve a 21st century infrastructure. **Goal:** Reduce costs while maintaining required military capabilities across all DoD mission areas. (DoD-6)

**DoD Functional Area Reform Goals.** Most major DoD functional areas have also established performance improvement reform objectives and goals. This report pertains to achievement of the following functional area objectives and goals.

- **Acquisition Functional Area. Objective:** Delivering Great Service. **Goal:** Achieve visibility of 90% of DoD material assets while resupplying military peacekeepers and warfighters and reducing average order to receipt time by 50%. (ACQ-1.2)
- **Acquisition Functional Area. Objective:** Internal Reinvention. **Goal:** Eliminate layers of management by streamlining processes while reducing the DoD acquisition-related workforce by 15%. (ACQ-3.1)

- Acquisition Functional Area. **Objective:** Internal Reinvention. **Goal:** Dispose of \$2.2 billion in excess National Defense Stockpile inventories and \$3 billion in unneeded Government property while reducing supply inventory by \$12 billion. (ACQ-3.3)

## Methodology

**Use of Computer-Processed Data.** To achieve the audit objectives we relied on computer-processed data from the DoD DD 350 data base for contract actions over \$25,000. The computer-processed data were determined reliable based upon the significant number of contract actions we reviewed and compared to the DD 350 output. Although we did not perform a formal reliability assessment of the computer-processed data, we determined that the contract delivery order numbers, award dates, and amounts generally agreed with the information in the computer-processed data. We did not find errors that would preclude use of the computer-processed data to meet the audit objectives or that would change the conclusions in the report.

**Universe and Delivery Orders Reviewed.** Table 8 summarizes the DLA delivery orders reviewed on Allied Contract SPO500-96-D-9502.

<b>Table 8. DLA Delivery Orders Reviewed on Allied Contract SPO500-96-D-9502</b>				
<b>Over \$25,000</b>				
<b>FY</b>	<b>Total Delivery Orders</b>		<b>Delivery Orders Reviewed</b>	
	<b>Number</b>	<b>Amount</b>	<b>Number</b>	<b>Amount</b>
1996	70	\$5,825,583	64	\$4,861,191
1997	107	\$14,235,381	99	\$13,521,560
<b>Subtotal</b>	<b>177</b>	<b>\$20,060,964</b>	<b>163</b>	<b>\$18,382,751</b>
<b>Under \$25,000</b>				
<b>FY</b>	<b>Total Delivery Orders</b>		<b>Delivery Orders Reviewed</b>	
	<b>Number</b>	<b>Amount</b>	<b>Number</b>	<b>Amount</b>
1996	398	\$2,057,297	83	\$920,330
1997	1,275	\$3,271,014	162	\$1,218,455
<b>Subtotal</b>	<b>1,673</b>	<b>\$5,328,311</b>	<b>245</b>	<b>\$2,138,785</b>
<b>Total</b>	<b>1,850</b>	<b>\$25,389,275</b>	<b>408</b>	<b>\$20,521,536</b>

## **Appendix A. Audit Process**

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**Cost Impact in Constant Dollars.** To determine the cost impact in 1998 constant dollars, we used DoD deflators from the "National Defense Budget Estimates for FY 1998," March 1997, to calculate DoD Allied commercial catalog prices and previous noncommercial prices in constant 1998 dollars. Detailed analysis schedules for the parts reviewed were provided to DLA headquarters and each supply center.

**Audit Type, Dates, and Standards.** We performed this program audit from June 1997 through June 1998 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Accordingly, we included tests of management controls considered necessary.

**Contacts During the Audit.** We visited or contacted individuals within the DoD and Allied Signal Incorporated. Further details are available on request.

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## **Appendix B. Summary of Prior Coverage**

### **General Accounting Office**

**General Accounting Office (GAO) Report No. NSIAD-95-64 (OSD Case No. 9853), "Defense Inventory: Opportunities to Reduce Warehouse Space," May 24, 1995,** indicates that there is substantial inventory that may never be used and a careful review of items most likely not to be used may reduce the number of items stored as well as storage space. About 84,000 of the items GAO reviewed had more than a 20-year supply and much of this inventory will likely never be used. Many items had deteriorated to the point that they were no longer usable. GAO recommended that the Secretary of Defense instruct inventory control points and program managers to focus their inventory reduction efforts on the material that occupies a great deal of storage space with more than a 20-year supply. Management generally agreed that inventories should be reduced and excess storage capacity should be eliminated.

### **Inspector General, DoD**

**Inspector General, DoD, Report No. 98-088, "Sole-Source Prices for Commercial Catalog and Noncommercial Spare Parts," March 11, 1998,** indicates that DLA purchased commercial catalog and noncommercial spare parts from Boeing at a significantly higher price than the competitive prices DoD previously paid for the items. DLA paid an average of about 172 percent or \$3.2 million more than the fair and reasonable prices. DLA also charged its customers an average cost recovery rate of 28 percent (about \$2 million) for its services in procuring Boeing commercial catalog items. DLA provided questionable value for those charges and DoD was not reaping the benefits foreseen for the DLA corporate contracting initiative.

The report recommended that the Under Secretary of Defense for Acquisition and Technology take appropriate action to provide the Military Departments with local purchase authority for centrally managed commercial items, when sources other than DLA offer the best value. The report also recommended that the Director, DLA improve management controls for sole-source procurements, commercial item pricing, and corporate contracting. The Under Secretary of Defense for Acquisition and Technology and DLA concurred with the report and are taking appropriate action.

**Inspector General, DoD, Report No. 98-064, "Commercial and Noncommercial Sole-Source Items Procured on Contract N000383-93-G-**

## Appendix B. Summary of Prior Coverage

**M111," February 6, 1998,** indicates that DLA paid (for sole-source commercial items) modestly discounted catalog prices that were significantly higher prices than the cost-based prices DLA previously paid for the items. As a result, DoD was not reaping the benefits anticipated when procuring commercial items. For CYs 1994 through 1996, DLA paid about [REDACTED] (in 1997 constant dollars) or an average of about [REDACTED] percent more than fair and reasonable prices for [REDACTED] of commercial items.

The report recommended that the Under Secretary of Defense for Acquisition and Technology provide additional guidance and training to the DoD acquisition community on purchasing commercial items from sole-source suppliers. The report recommended that the Director, Defense Logistics Agency require contracting officers to obtain uncertified cost or pricing data for commercial item procurements when needed to determine price reasonableness. The report also recommended that contracting officers procure economic order quantities, determine the reliability of data used for price analysis, and obtain certified cost and pricing data when required for noncommercial items. Management generally agreed with the recommendations, but presented a general theme that obtaining uncertified cost or pricing data to determine the reasonableness of contractor prices was an option that should be seldom used. The DoD is appropriately reacting to the issues raised in this report by developing additional training for the acquisition corps to operate more effectively in the acquisition reform environment where commercial pricing and purchasing practices need to be better understood.

**Inspector General, DoD, Report No. 96-090, "Local Procurement of Centrally Managed Items," March 29, 1996,** indicates that DoD needs to address a variety of issues to successfully implement its initiatives to increase the use of local purchase authority and to focus the role of the central supply system on managing items where value is added. The audit was unable to determine the extent of local procurement of centrally managed items. However, procurement data provided by 13 organizations visited during the audit showed that only \$7.2 million of \$744 million (less than 1 percent) of the local procurements were for centrally managed items.

The report recommended that the Deputy Under Secretary of Defense (Logistics) develop procedures to have requisitioning organizations make greater use of local purchase authority for centrally managed items when local procurement is in the best interests of the Government; direct that requisitioning organizations develop procedures to determine the total cost of a local procurement; develop a detailed strategy to address the impact of the local purchase initiatives on centralized material management; and develop procedures addressing local procurement when inventory control points have excess stocks, reporting and recording of demand data for local procurements, and feedback on the progress and economies of local purchase initiatives. Management indicated that the audit results were

## Appendix B. Summary of Prior Coverage

already being put to use, concurred with the intent of all recommendations, and proposed alternate methods to meet the goals of the recommendations.

**Inspector General, DoD, Report No. 95-165, "Purchases of Consumable Items Transferred to the Defense Logistics Agency," April 4, 1995,** indicates that purchases of consumable items were not properly recorded in the DLA requirements determination system after management of the items was transferred to DLA, and requirements for the purchase of consumable items were not being adequately reevaluated before award of contracts. Inventory control points of the Military Departments and DLA were purchasing material valued at \$9.2 million for the 37 items they reviewed. Approximately \$2.7 million of the inventory purchases were in excess of current requirements.

The report recommended that the Military Departments and DLA implement specific internal control procedures to ensure that the Military Department purchase requests are properly recorded in the DLA requirements determination system and that the Military Departments discontinue management of the items when item management is transferred to DLA. The report also recommended that procedures be developed and implemented for DLA inventory managers to obtain current and accurate requirements information from the Military Department inventory control points after management of the item transfers to DLA. Management generally agreed with the recommendations and described actions taken and planned.

## Appendix C. Allied Calculation of Minimum PLT/DVD Savings From Corporate Contract

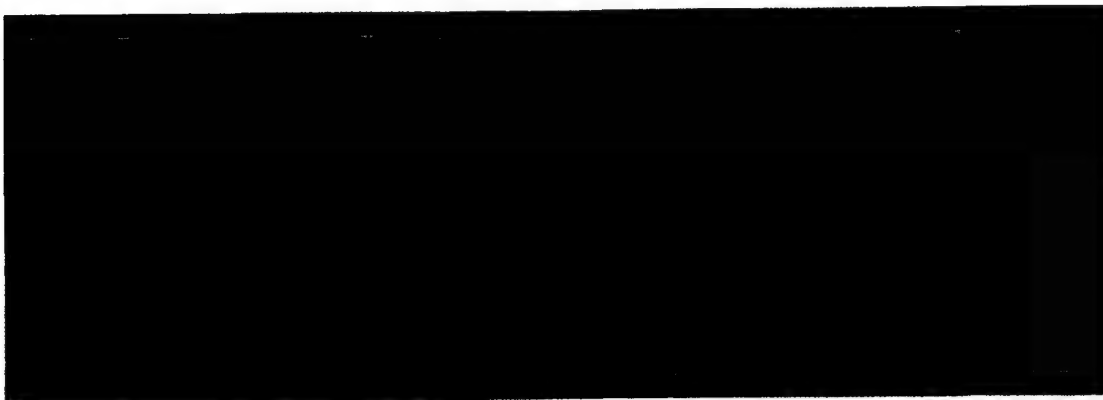
[illegible]

**Darkened areas (blank spaces) of this report represent data considered "Allied Proprietary" which has been deleted.**

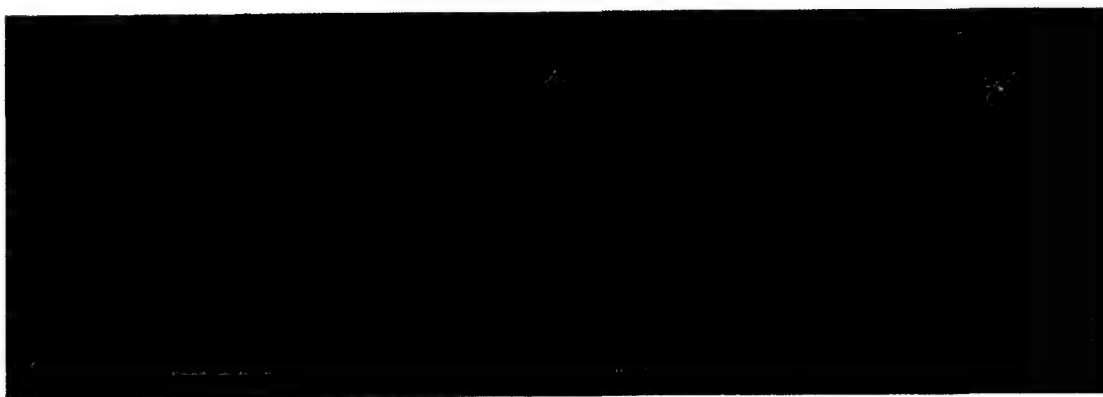
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## **Appendix D. Allied Catalog - Days to Delivery**

### **1996 Allied Commercial Catalog.**



### **1997 Allied Commercial Catalog.**



### **1998 Allied Commercial Catalog.**



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## **Appendix E. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition and Technology\*  
Deputy Under Secretary of Defense (Acquisition Reform)\*  
Deputy Under Secretary of Defense (Logistics)\*  
Director, Defense Logistics Studies Information Exchange  
Director, Defense Procurement\*  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)  
Assistant Secretary of Defense (Public Affairs)

### **Department of the Army**

Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Financial Management and Comptroller)  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Other Defense Organizations**

Director, Defense Contract Audit Agency\*  
Director, Defense Logistics Agency\*  
Commander, Defense Contract Management Command\*  
Commander, Defense Contract Management Command Phoenix  
Commander, Defense Supply Center Columbus\*

\*For Official Use Only and sanitized versions. Other addressees will receive the sanitized version only.

## **Other Defense Organizations (cont'd)**

Commander, Defense Supply Center Richmond\*  
Commander, Defense Industrial Supply Center Philadelphia\*  
Director, National Security Agency  
Inspector General, National Security Agency  
Inspector General, Defense Intelligence Agency

## **Non-Defense Federal Organizations**

Office of Management and Budget  
Technical Information Center, National Security and International Affairs Division,  
General Accounting Office  
Office of Federal Procurement Policy

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations\*  
Senate Subcommittee on Defense, Committee on Appropriations\*  
Senate Committee on Armed Services\*  
Senate Subcommittee on Acquisition and Technology\*  
Senate Committee on Governmental Affairs\*  
House Committee on Appropriations\*  
House Subcommittee on National Security, Committee on Appropriations\*  
House Committee on Government Reform and Oversight\*  
House Subcommittee on Government Management, Information and Technology,  
Committee on Government Reform and Oversight\*  
House Subcommittee on National Security, International Affairs, and Criminal Justice,  
Committee on Government Reform and Oversight\*  
House Committee on National Security\*

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## **Part III – Management Comments**

# Defense Logistics Agency Comments



IN REPLY  
REFER TO

DDAI

**DEFENSE LOGISTICS AGENCY**  
**HEADQUARTERS**  
8725 JOHN J. KINGMAN ROAD, SUITE 2533  
FT. BELVOIR, VIRGINIA 22060-6221


30 SEP 1998

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL FOR AUDITING,  
DEPARTMENT OF DEFENSE

SUBJECT: Commercial Spare Parts Purchased on Corporate Contract SPO500-96-D-9502,  
7CF-0058

Enclosed are our comments to your request of 23 July 1998. If you have any questions,  
please call Sharon Entsminger, 767-6267.

Encl

  
JEFFREY GOLDSTEIN  
Chief (Acting), Internal Review Office

Cc:  
DLSC-BO  
DLSC-PPB  
DSCR-DI  
DCMC  
DSCC-DI  
DISC-DI  
DESC-DI

Federal Recycling Program



Printed on Recycled Paper

30 SEP 1998

**SUBJECT:** Commercial Spare Parts Purchased on Corporate Contract  
SPO500-96-D-9502, 7CF-0058

**FINDING: Buying Commercial Spare Parts**

Defense Logistics Agency Supply Centers paid higher prices for commercial spare parts on contract SP0500-96-D-9502 (the Allied corporate contract) when compared to previous noncommercial prices for the same items. The supply centers failed to effectively implement buying and inventory management practices designed to offset the higher commercial prices and take advantage of the contractor's capabilities. Specifically, the supply centers failed to:

- remove breakout items (items that could be procured from other than the original equipment manufacturer) and other Allied spare parts with significant price increases from the contract;
- determine whether delivery times published in the Allied commercial catalog were adequate to support DLA customer requirements and determine whether Allied could meet required delivery times;
- implement procedures to use direct vendor delivery, the chosen method of support for the contract, versus stocking items in defense depots; and
- implement procedures to provide Allied with reasonably accurate demand forecasting, coordinate proposed commercial item technological improvements with the DoD acquisition team, and establish metrics to monitor Allied's contract performance.

These failures occurred because DLA had not yet formulated good procurement and management strategies for commercial parts in the acquisition reform environment. As a result, DLA supply centers paid Allied commercial prices for spare parts which included cost for Allied to manage, stock, and deliver the items directly to DoD users (DLA customers). However, instead of taking advantage of these commercial services, the supply centers purchased large quantities of parts for inventory and applied their full cost recovery rates to manage, stock, and deliver the items to its customers. Duplication of costs to manage, stock, and deliver

1

the items increased DLA customer cost by about \$3.2 million in FYs 1996 and 1997. Based only on the data reviewed for FY 1997, we calculate that DLA supply centers can reduce total ownership cost for their customers by at least \$12.5 million during FYs 1999 through 2004 if the Allied corporate contract is effectively implemented as intended.

### **DLA COMMENTS: Concur.**

The contract covered by this audit was one of the first prototype contracts awarded by DLA under a reengineering program to shift to best commercial practices. This contract covered the total requirements of the hardware ICPs for AlliedSignal (Allied) commercial spare parts for a five year period. The contract envisioned reliance on electronic commerce and on the contractor's infrastructure and commercial distribution system supply.

We agree with the IG finding that we launched this new commercial practices program before we established procedural guidance of the sort recommended by the IG. However, we were concerned that delaying implementation would pose serious problems in absorbing workload increases of about 0.9 million consumable items transferred to DLA under the Defense Management Review Decisions. And, while we did not have procedures or training in place, we believed it was prudent to move forward to accommodate the increasing demands placed on the agency in a tight resource environment.

Some of the matters identified in the report are ones DLA was addressing earlier. Some actions were to correct difficulties in getting parts from this particular sole source supplier; others were more broad-based, including policy, training, and operational changes as a result of experiences gained under the other prototype contract. Notwithstanding our efforts, however, the IG's in-process review has benefited the agency by identifying new problems or confirming suspected problems. As a result, we are better able to correct specific problems and institutionalize broad policy and procedural improvements as early as possible, consequently benefiting from cost avoidance savings.

To summarize, our strategy for moving quickly to adopt best commercial practices did not initially include all the protective mechanisms listed in the IG's finding. However, despite this, we believed moving forward quickly was the better approach, knowing that, as in any new program,

improvements would be made as the program evolved. The necessary guidance and procedures are now developed, or are in the process of being developed, and corrective actions should be completed shortly. This will enable DLA to achieve and pass on to Military customers the opportunity savings that were originally planned under this contract.

## **BACKUP INFORMATION FOR DLA's POSITION**

### **BACKGROUND INFORMATION**

During the early 1990's DLA's Defense Personnel Support Center's Medical Directorate began to adopt commercial buying practices in establishing long-term "corporate" contracts covering a manufacturer's full product line. Such long-term partnerships access the contractor's commercial distribution systems for direct delivery of pharmaceuticals to Military hospitals in lieu of continued reliance on issuance from the Military depot system. As noted in the draft report, our Military customers benefit in lower product cost, ease of use, and improved deliveries. And the opportunity to reduce our customer support infrastructure, including procurement and depot distribution systems, enables reductions in our fee for services.

In 1995 DLA initiated an accelerated effort to spread adoption of corporate contracting and other best business practices to our Hardware ICPs. The contract with Allied (the subject of this IG audit) was one of the first corporate contracts awarded by a DLA "Hardware" Inventory Control Point (ICP)—i.e., Defense Industrial Supply Center (DISC), Philadelphia, PA and Defense Supply Centers Columbus (DSCC), OH and Richmond (DSCR), VA. The DISC award (December 21, 1995) was a three-year fixed price contract with two one-year options covering Allied's commercial catalog. Preaward sampling analysis had shown the items to be commercially available and a comparison of discounted prices against previous prices paid by the Government indicated the overall pricing under the corporate contract would be fair and reasonable. The determination that the corporate contract was in the best interests of the Government took into account more than just the unit prices of the individual items as compared to previous purchases of the same items. It projected that inventory savings would be generated as a result of taking advantage of Allied's infrastructure to provide supply chain support and the elimination of item stockage in the Military depots. Although item costs would increase, further offsetting savings would be realized by issuing individual electronic delivery orders against the corporate contract vice negotiating and awarding individual purchase orders.

### **ASSESSING CONTRACTOR PERFORMANCE**

Six months after DISC's award of the corporate contract, DSCR became aware of sizeable price increases on some items for which they had recently been assigned logistical responsibility, when they began receiving item requisitions from military customers (June 1996). As a result, DSCR concluded closer price scrutiny of these items was warranted and the contract was not loaded into the DLA standard automated Paperless Order Processing System (POPS). (Long term contracts normally are loaded into POPS because item pricing has been validated during preaward review.) Contracting personnel at our other Hardware ICPs likewise began to experience problems securing timely deliveries and adequate sales or pricing data to justify apparent excessive prices on some parts. Numerous discussions with Allied became necessary in attempts to achieve reasonable pricing and deliveries for some items. Meetings were held with Allied representatives at DSCR in October 1996 and at DISC in February 1997 in unsuccessful efforts to resolve a broadening pattern of excessive prices and late deliveries.

Following the meeting at DISC, DISC initiated a comprehensive assessment of contractor performance and pricing under the corporate contract (March 1997). DISC documented that item prices were excessive when compared to prices historically paid to Allied prior to award of the corporate contract. Although the contract had been planned principally for direct vendor delivery (DVD), when contracting officers found that customer needs were not being supported on a timely basis via DVDs, they placed stock replenishment orders to prevent supply support failure. However, delinquency problems were also confirmed on orders for depot stock replenishments. Following completion of DISC's review, various ICP managers redoubled efforts to resolve the problems their ICPs were having under the corporate contract. In addition, senior DISC management met at Allied (May 1997) to seek an approach to resolve these difficulties.

### **COORDINATED CORRECTIVE EFFORTS**

**Command.** The DLA Deputy Director (Materiel Management) issued a comprehensive "action" memorandum to the Hardware ICP Commanders on June 9, 1997 (subject: Action Items from DoD Inspector General (IG)

Brief), addressing problems being reported by the IG concerning its audits of the first corporate contract awarded by a DLA Hardware Center and another contractor.

**Joint Meeting.** A joint meeting was held with Allied at DSCR in June 1997 (with DSCC, DISC, and DLA representation) in a coordinated effort to resolve the difficulties that were imperiling this effort to employ commercial practices. Some minor breakthroughs were achieved to resolve several specific impasses, but a general solution was not yet attainable.

**IG Audit Initiated.** Subsequently, in August 1997, the IG issued an announcement letter advising DLA that it was initiating a review of prices being paid for Allied parts.

**ICPs Continued Dialog.** DSCR management successfully concluded negotiations on three items (August 1997). And in September 1997, DSCC management held further discussions with Allied.

**Demand Forecasting Conferences.** Allied had historically held these conferences with its major commercial customers and had felt that access to the ICPs demand forecasting would be instrumental in its ability to secure items in advance of impending delivery orders. Accordingly, Allied had secured the requirement for these conferences to be incorporated into the corporate contract. At the December 1997 conference, it was agreed that quarterly meetings would be held to provide forecast data based on demand history. Agreement was reached to review pricing on 200 NSNs meeting certain price increase percentages and annual demand values. The first 67 items were furnished. In February 1998, DLA requested Allied evaluate pricing on an additional 127 items. Allied responded that commercial sales data did not exist on over half the items.

**Comprehensive Assessment.** In March 1998, DLA initiated an intensified assessment of DLA purchases under the corporate contract, to be followed by a review of all other DLA buys from the contractor. The Hardware ICPs identified another 73 "high risk" items Allied was requested to evaluate.

**MOA on Action Plan.** A video teleconference (VTC) involving senior officials of DLA and Allied, including the Commander, Defense Logistics Support Center, and Allied's Vice President for Military Programs and Military Customer Support, was held on April 29, 1998 to review problems

and the potential for curing vice abandoning the business arrangement. Several follow-on working-level VTCs resulted at bi-weekly intervals to review alternatives and decide on a resolution action plan.

**DLA Negotiation Team.** A DLA Negotiation Team of Hardware ICP representatives under DSCR leadership was established in April 1998 to work with Allied towards a global resolution, including removal of delivery and price outliers from the corporate contract and repricing as warranted. At present, the global resolution has not yet been completed. However, the ICPs identified 230 items that have been removed from the contract (administrative modification P0008, dated August 21, 1998) due to an unacceptable price and/or delivery time frame. At one time, it was estimated that 5,735 items were covered under the contract. As of July 31, 1998, 834 different items has been bought thereunder since its inception. All but 790 of the 5,505 remaining available items were eliminated as a result of the renegotiation effort (by modification P0007, effective September 2, 1998). The outliers will be repriced by Allied and added to an existing DSCR Indefinite Quantity Contract (IQC). In addition, the DLA Negotiation Team has been discussing the possibility of a test of Allied's ability to meet commercial normal, critical, and urgent timeframes (see Recommendation 5).

These actions are in accordance with DLA's corrective action plan worked out with Allied's management, which was consistent with prior guidance we had issued (our June 9, 1997 memorandum to our Hardware ICP Commanders).

DLA has taken aggressive action to respond to the issues raised by the IG. This comes at an increasingly challenging period. We are continuing to assimilate the consolidation of inventory control points, the transfer of item management responsibility for consumable items from the Military Services to DLA, and the recent changes in the law regarding the acquisition of commercial items. To meet these challenges, DLA is continuously seeking more efficient and responsive logistics management solutions to meet the needs of the war fighter while simultaneously achieving the lowest possible costs for both the customer and the taxpayer. In spite of several bumps along the road that have been highlighted by the IG, we believe that corporate contracts are proving to be a beneficial initiative for DLA and its customers. As noted in first paragraph of the "Summary," page 26 of the draft:

7

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“...if DLA and Allied can make the contract work as intended and control commercial price increases, the contract may provide an effective vehicle for DoD to procure commercial spare parts and achieve the related GPRA DoD Functional Area Reform Goals.”

As pointed out below (“Miscellaneous” issue #6, page 12 of this response), we have succeeded in resolving these difficulties and expect that the contract will “work as intended.”

**MISCELLANEOUS OTHER DRAFT REPORT ISSUES**

1. Inasmuch as the corporate contract has now been significantly reduced in scope to 790 items due to removal of price and delivery outliers, the five year cost avoidance savings reported in the last paragraph of the finding (“Buying Commercial Spare Parts,” page 5 of the draft) may need updating.

2. We request a clarification be added to the following statement (first paragraph of “Spare Part Breakout” section, page 12 of the draft), to explain the context in which DLA Hardware ICPs used this corporate contract in what would appear to be an inappropriate manner:

“Although the contract was intended only for the purpose of sole-source Allied spare parts (parts that Allied controls the technical data rights to), the supply centers used the contract to procure items that could have been procured from the actual manufacturers at lower prices.”

We understand the audit conclusion that certain items can be bought from actual manufacturers was based on followup contact with previous suppliers to confirm that they actually produced the items. Our initial review indicates that some of these suppliers are not actual manufacturers for the parts in question. Some are dealers, including non-stocking parts locators and suppliers of surplus parts. Our systems records likewise have been found to misidentify a non-manufacturing source as a manufacturer. However, these items were coded as noncompetitive at the time the orders were placed under the corporate contract, so the buyer relied on this information in concluding that the items were sole-source Allied parts.

3. We suggest clarification in a comment made in the back-up to the finding ("DLA Supply Centers Failed to Implement DVD Procedures," page 17 of the draft). Contrary to what the current wording implies, the ICPs took appropriate action when:

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"...the items were not loaded into the Paperless Order Placement System (POPS) for various reasons including the fact that times published in the Allied catalog often did not meet the DoD delivery requirements."

Since the contractor could not meet the customers' delivery timeframes, POPS DVD support should not have been utilized, and it wasn't.

4. We would also like to offer some thoughts for consideration regarding a statement ("Metric to Evaluate Commercial Price Increases," page 22 of the draft) that:

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"The metric should measure the contractor price increases on an annual basis to ensure that increases are in line with the rate of inflation and the commercial market. For example, if the commercial market expanded to eliminate sole-source contractors and produced better competitive prices for the same or similar items than the price increases should be comparable to those of the commercial market."

We agree that knowledge of the price trend in a specific marketplace would be important in dealing with suppliers of *competitive* commercial items. This is true because the Government has a good chance of including an economic price adjustment clause utilizing a price index or published market price rather than a clause providing for increases based on changes in catalog prices. Or, if the supplier has a catalog price and insists on adjustments based thereon, we could include a provision limiting price increases to the amount of increase in a corresponding index or market price. However, our early corporate contracts awarded by the Hardware ICPs generally involved sole source suppliers. The contracts were intended to minimize the logistics costs for filling small repetitive requirements to suppliers of *noncompetitive* items. We have minimal leverage in these situations and corporate contracts provided that changes in the catalog price be incorporated into the contract. In dealing with sole source suppliers, the choice our contracting officers often face is either to accept it or not buy the sole source item for our customer. There is little likelihood that the situation will change (i.e., that sole-source suppliers would be eliminated.) Further,

the catalog prices for noncompetitive items would likely increase at a greater rate than for comparable items facing the natural constraints on price growth resulting from competitive market forces. Knowledge of the existence of any such price trend difference is important, but attaining price reductions or rollbacks when purchasing in a "take it or leave it" sole source environment is exceedingly difficult, at best.

5. DLA POPs Cost Recovery Rates (CRRs) cannot be meaningfully compared to the GSA surcharge (third paragraph of "Duplicating Costs to Manage, Stock and Deliver Spare Parts" subsection, page 25 of the draft):

"Another area of concern is the significant difference between POPs non-stocked cost recovery rates at the DLA supply centers, ranging from 7.6\* to 18 percent. In comparison, the General Services Administration charges its customers a one percent industrial funding fee for all orders placed under multiple award schedule contracts. The one percent fee covers the spectrum of administrative costs to manage the program from market research, procurement planning, solicitation issuance, evaluation of proposals, negotiation and award, contract administration, marketing publications, etc."

\* If this portion of the comment is retained, the wording should clarify whether it is citing FY 1998 CRRs, in which case the lowest ICP POPs rate is 7.4 percent (7.6 percent was the lowest in FY 1997). The low POPs CRR drops to 7.0 percent for FY 1999.

The draft compares the CRRs of two Agencies that have completely different funding streams and customer services, without any analysis and offsets to compensate for those differences.

DLA receives no appropriated money to offset the cost of providing supplies to customers. DLA, of course, is not a separate, independent Agency, but rather, an activity within the DoD. DLA is required by law to recover all of the costs required to provide customers material. In addition, DLA is required to recover other DoD-related costs in its surcharges. We have no knowledge of whether the one percent rate was established as a business decision and the extent to which it covers total costs.

Consider the nature of the 4 million military unique items DLA manages and is responsible for providing to satisfy the peacetime needs of military

customers, and to be in a position to support much greater war-time needs on an immediate ramp-up basis. Compare this to the complexity of contracting for customer support of a smaller number of generally, commercial off-the-shelf items covered under Supply Schedules, for which safety levels need not be available in the event of contractor failure to provide timely supply support.

There is no discussion as to what customer service costs are included in the CRRs for each Agency, nor is there any adjustment for differences in services provided. A direct comparison without this type of assessment is invalid. Embedded in DLA's costs are readiness costs---the costs of Command Control Centers, 24 hour Emergency Supply Operations Centers, Customer liaison activities, purchase and storage of safety levels, airlift service, etc. Additionally, customers purchasing material from DLA are entitled to: expedited delivery and diversions upon request; delivery anywhere in the world at one standard price; return excess material; return discrepant material for replacement; DLA investigation of discrepant materials; etc. We are unaware that GSA items are shipped outside the continental U.S. or that GSA offers these other services. The value of unique services not common to both Agencies must either be eliminated from the rate of the one Agency offering such unique services or added to the rate of the other Agency, before a valid comparison can be made.

Cost allocations from outside an ICP comprise most of our POPs CCR(s). For example, the FY 1999 DISC POPs CRR surcharge will recover pro-rata shares of the costs of:

- (i) DISC operations;
- (ii) distribution depot operations;
- (iii) material-related expenses (testing including First Article Testing; first destination transportation costs, second destination costs, packaging, the purchase of technical drawings);
- (iv) overocean transportation, including allocations for the Consolidation and Containerization Points,
- (v) Defense Automated Addressing System Office (i.e., share of costs of automated military requisition message system routing);
- (vi) Defense Finance and Accounting System (DFAS) (i.e., for billpaying and interdepartmental reimbursement from Military customers);
- (vii) DLA HQ and Defense Logistics Support Command;

(viii) Defense Information Systems Agency (DISA) (i.e., for computer services); Defense Logistics Information Services (DLIS) (i.e., share of cost of maintaining the National Stock Number cataloging system of items used by DoD, other Federal Agencies, and NATO Countries); Defense Reutilization and Marketing Services (DRMS) (i.e., for reutilization or disposal of military unique and commercial items); etc.; and  
(ix) other allocations (i.e., DoD price stabilization, etc.).

In summary, GSA makes a valued contribution towards meeting the Government's operational needs. However, we believe a mere rate comparison overlooks the distinctly greater costs for DLA support services coincident in meeting the Military's hardware needs. The draft should include the necessary adjustments by eliminating the costs of additional services included in our POPs CRR(s), before a valid, direct comparison can be made. Otherwise, the quotation, which provides the allusion of comparability, should be deleted.

6. Finally, request update of the audit summary (first and second paragraphs, respectively of "Summary," page 26 of the draft), which states that:

"If breakout items and about 10 percent of the Allied commercial items (38 orders) that showed significant price increases were removed from the corporate contract, prices for the majority of the items on the corporate contract would be in-keeping with previous prices."; and

"...DLA and Allied must still demonstrate that they can make the contract for commercial spare parts work as intended. Otherwise, DLA will need to revert back to the previous buying practice of negotiating better prices for the spare parts..."

DLA has taken aggressive action by eliminating all but three of the breakout items and *all* of the price and delivery outliers. Future prices will be "in-keeping with previous prices." This demonstrates that DLA "can make the contract for commercial spare parts work as intended."

**RECOMMENDATION 1:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to determine which items on the contract are not Allied sole source items and procure those items directly from the actual manufacturers when that is determined to be the best value for DoD and its customers.

**DLA COMMENTS: Concur.**

This issue came up in connection with the preceding IG audit, which likewise covered an entire commercial spare parts catalog. During the course of that audit we addressed the regulatory and practical needs for distinguishing between sole source and competitive items in a June 9, 1997 memorandum to our Hardware ICP Commanders, subject: Action Items from DoD Inspector General (IG) Brief. We stated that:

"Those items that can be bought competitively using Government-owned drawings...should be identified and actions taken to assure future buys are competed...We understand DISC has already taken the first step in exceptioning requirements to enable competition to be obtained for the items in the...contract that should not have been established for automated ordering via POPS.";

"We need to assure that manufacturing drawings necessary for a competitive buy are located and obtained in time for your first buy following transfer. For items that have already been transferred, we need to assure that any technical data needed for competing subsequent buys is also obtained promptly. Provide your plan of action to remedy this situation with your response.";

"Safeguards must be in place to preclude a sole source corporate contract intended for small quantity DVD requirements from being used for large volume procurements of any type unless, following competition, such contract prices and terms result in the best value support alternative.";

"Because it may be beneficial or expedient to cover a contractor's entire parts catalog in a corporate contract, even though it includes competitive items or items available from its dealers or independent agents, you may need local procedures to assure requirements for such items are not

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set up or enabled to flow nonstop into POPS or other automated or manual ordering methods. If this is currently happening for material requisitions for items you manage (both stocked and non-stocked), you should assure this is corrected.”; and

“We believe changes to our current practices for placing orders under long-term contracts are needed to assure that each requisition is filled in the most advantageous manner for each customer. In furtherance of this objective, we believe that changes to preclude automatic order placement practices are needed...”

The IG reported (“Spare Parts Breakout” subsection, page 12 of the draft) that Table 1 (page 10 of the draft) showed 46 of the 418 NSNs reviewed under this audit were not sole-source Allied and could be procured from the actual manufacturers at significantly lower prices. (We subsequently resolved with the IG that this meant that there were 46 buys of 36 NSNs that had previously been bought from a different manufacturer, out of a total of 418 orders they audited covering 306 different NSNs.) The draft also states that DISC had taken corrective action to remove other breakout items from the contract, which the IG therefore had not included in the above summary numbers. These 10 other items are listed in Table 3 (page 13 of the draft). DISC has confirmed that this screening recommended by the IG has already taken place and the DISC Corporate Contracting Officer has taken the necessary action. Specifically, we were advised by DISC that:

“In February 1997 we issued directions to the CBUs [Commodity Business Units] that they must solicit any approved sources for items on the Allied Contract and in the event that they couldn't get a quote from the approved source or any dealer, they would return the PR [purchase request] to ABLP [DISC's Corporate Contracting Office's symbol] and ABLP would only then place the order against the corporate contract. We further advised the CBUs that complete documentation of the efforts to obtain pricing from other sources must be in the PR folder before ABLP would accept it for award against the Corporate Contract. POPS had previously been screened by looking at AMC/AMSC codes to ensure that there were no competitive items in POPS.”

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Likewise, DSCC has advised that they have identified and removed the competitive items from the contract and are in the process of forwarding them to Technical for analysis of possible additional sources. DSCC has also identified potential Service and Sales licensee items.

And finally, DSCR has advised that items which are not sole source to Allied would be removed during the then on-going negotiations with Allied. DSCR advised that it has in place a stringent process for screening items to identify them as sole source for inclusion in a corporate contract. During the process, the Equipment Specialist reviews the technical folder for the item. If past procurement history reflects contracts to companies other than the Original Equipment Manufacturer (OEM), the Equipment Specialist validates whether the contract was to a supplier or an actual manufacturer. The Product Centers have an Equipment Specialist dedicated to working with the Corporate Contract Specialist. Their role is to screen items to be put on corporate contracts, validating that the current information identifies the item as sole source.

We have confirmed that 7 of the 36 previous breakout items, plus 1 of the 10 DISC items returned to breakout, were included in the administrative modification (P0008) that formally removed 230 NSNs from the corporate contract. A second modification (P0007) removed all remaining items from the contract except for 790 specific sole source items to be retained on the contract. We note that only 2 of these 36 items are being retained plus 1 of the 10 additional DISC items. All 3 carry an Acquisition Method Code/Acquisition Method Suffix Code (AMC/AMSC) code of "3H" ("Acquire directly from the actual manufacturer" because "The Government physically does not have in its possession sufficient, accurate, or legible data to purchase this part from other than current source(s).").

Although 31 of the 43 items that were deleted currently bear a competitive code, the remaining 12 items carry non-competitive item coding (AMC/AMSC of "3A," "3H," or "3P"). We understand that several of the previous non-Allied sources are dealers, and one is a surplus parts dealer. The fact that a buy has previously been obtained from another source does not necessarily mean that the item has been "broken out" for competition. Our ICPs sometimes purchase items from new parts dealers, including previously-excessed sole source items.

To summarize, we concur in the recommendation, and have addressed these matters in the aforementioned correspondence with the Hardware ICP Commanders. However, we will write the ICPs for a status report and estimated completion of breakout review efforts on the remaining 15 items in question that are still coded noncompetitive. We will ask for a technical review of the items as breakout candidates. This may lead to review and approval of the alternate item(s) by the Military engineering support activity responsible for configuration management. We will track progress until completion of all breakout efforts on these items and obtain a final report of "before and after" AMC coding.

**DISPOSITION:** Ongoing. **ECD:** March 31, 1999.

**RECOMMENDATION 2:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to determine which Allied parts should be procured on the corporate contract and which parts should be procured for stock on another contract based on the best value to DoD and Defense Logistics Agency customers.

**DLA COMMENTS:** Concur.

As pointed out in comments to the preceding audit recommendation, all but 790 items were eliminated from the corporate contract. The price and/or delivery outliers will be repriced and added to an existing DSCR IQC contract.

These actions are in accordance with DLA's prior guidance contained in our June 9, 1997 memorandum to our Hardware ICP Commanders (subject: Action Items from DoD Inspector General (IG) Brief), and the action plan agreed to with the contractor to resolve the current unsatisfactory execution of the corporate contract. We stated in that memorandum that:

"Some difference should be expected in converting from volume purchases for stock to buys on demand. But apart from that, you must decide whether the current method of support was the most advantageous alternative for each of these buys.";

"...you risk falling short of expectations whenever you fail to utilize the most advantageous source available. You should be paying the best price available for the customer support and delivery needed.";

"Early corporate contracts such as the Boeing corporate contract were established to buy noncompetitive items using the same terms and prices accorded the contractor's "retail" customers (end users). They provided direct vendor delivery (DVD) of commercial or other readily available noncompetitive items needed quickly in small quantities. Accordingly, such contracts may not be the best value for stock buys, i.e. in large quantities, because you should be obtaining lower prices for volume buys. When purchasing for stock, we should not be paying contractor cost which include depot and distribution support costs.";

"The job has only begun once a corporate contract or other support arrangement is awarded. Do not assume use of a long-term contract is providing best value, or that you are getting what you contracted for. You need to monitor performance to assure you are getting the extra value you are paying for throughout the life of these contracts. When full value is not being realized, timely corrective actions must be taken. In addition to corrective actions under any particular order, as noted in PROCLTR 96-40, the contracting officer should pursue remedies such as: before exercising an available option, renegotiating the limits of the quantities ordered, price discount applicability, etc.; reaching agreement on a no-cost settlement; or even terminating for convenience, as determined appropriate and in the Government's interest.";

"Assure that before you exercise any option under these contracts, you have determined that any price growth is fair and reasonable and that supply availability and delivery time frames will likely be met based on the contractor's past performance record."; and

"...each Commander should assure that post-award reviews of prices, delivery, and other services covered by these support mechanisms have been made to assure long-term contracts are being used in the most beneficial manner for your customers and that you are receiving the delivery and other services paid for."

To summarize, we concur in the recommendation. The successful completion of the renegotiation effort under DLA's action plan will resolve the problem as intended by this recommendation. A part of the global resolution is the repricing of price outliers. This is in-process for the initial 37 outliers, which represent the most urgently needed items. Upon completion of the evaluation and negotiations, these items will be added to the DSCR IDC contract. This repricing effort will be an ongoing process as the need arises for the remaining items.

**DISPOSITION:** Ongoing. **ECD:** September 30, 1999.

**RECOMMENDATION 3:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to, in conjunction with Allied, determine which parts in the catalog can be supplied within 20 days (or the time necessary to meet direct vendor delivery requirements) regardless of the delivery time published in the catalog, and include only those parts on the contract.

**DLA COMMENTS:** Concur.

The recommended actions were part of the action plan agreed to with the contractor to resolve the current unsatisfactory execution of the corporate contract. Delivery outliers have been identified. Some were removed by the administrative modification number P0008, issued August 21, 1998; the remainder were deleted by bi-lateral modification P0007, effective September 2, 1998.

**DISPOSITION:** Completed.

**RECOMMENDATION 4:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center procure and inventory parts using a different contract when Allied cannot deliver items within the time necessary to satisfy direct vendor delivery requirements.

**DLA COMMENTS:** Concur.

Response is similar to that for Recommendation 3. Delivery outliers were identified. The DLA Negotiation Team negotiated a solution with Allied, i.e., to transfer to a different contract, those items with long lead times which the company decided it cannot support on a timely basis. Requirements for the first 37 sole source items are being repriced by Allied. The items will be added to the DSCR IQC and delivery orders issued to fill back-ordered requisitions. This process will be ongoing. Additional items will be priced and added to the IQC as stock reorder points become imminent.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**RECOMMENDATION 5:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to establish a test program with Allied to determine whether required delivery times for direct vendor delivery can be met. This test program should also determine whether Allied can meet commercial and contract urgent requirements for items such as "aircraft on ground" (4 hours) and "critical" (24 hours).

**DLA COMMENTS:** Concur.

Part of the agreement on correcting the problems on the commercial contract includes developing and fielding a "Live Fire" prototype with Allied to intensively measure Allied's ability to perform these functions for specified weapon systems. We are still discussing deploying the prototype on one weapons system (UH-1) with Allied. We have given them the parameters we want them to meet - performance, reliability, price and proven cost savings. Allied is examining the process and is expected to prepare an abstract in response to DSCR's standing Broad Agency Announcement for Virtual Prime Vendor support of individual or selected Military installations. If a contract results, performance measurement would likely not conclude before fiscal year end 1999.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**RECOMMENDATION 6:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center

Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to determine what commercial spare parts are currently in Defense Logistics Agency depots at levels that exceed current known requirements and, if feasible, initiate action to return these commercial items to Allied for future credit.

**DLA COMMENTS: Concur.**

DLA supports innovative efforts to reduce excess inventory and the cost of support to our customers. The return of excess material is not new, and most contractors are reluctant to accept such returns. Allied's commercial practice, however, is to accept returns for credit when a part is no longer required, and their standard clause was included in the corporate contract.

Due to the common inability of most of our Military customers to accurately forecast future needs, our ICPs experience a significant degree of unplanned requisitions as well as forecasts for unneeded items. Accordingly, concerns for receiving unanticipated demands following item returns dampens enthusiasm for extensive use of this technique.

Current stockage excesses are being identified in connection with efforts to reduce the impact of excessive price growth on this corporate contract. When properly employed, this enables us to minimize the impact of recent, higher priced buys which ultimately must be passed on to our customers.

There are potential costs that must be weighed in determining the feasibility of returning items to Allied. The potential costs include manual efforts required to work outside the automated tracking systems and potential fluctuations in demand that can make excess projections difficult. Nonetheless, we expect that the on-hand quantities of some commercial spare parts supplied under the Allied corporate contract are in excess of requirements and that such excess quantities will be returned for credit. We plan to formally address this matter in correspondence to the Hardware ICPs and monitor success in securing such agreement. We will track results of this effort and institutionalize appropriate general guidance.

**DISPOSITION: Ongoing. ECD: March 31, 1999.**

**RECOMMENDATION 7:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to instruct contracting officers not to place orders for commercial spare parts on the contract with delivery date that exceed 20 days or minimum direct vendor delivery requirements.

**DLA COMMENTS:** Partially concur.

The IG has prepared a well-documented overview of the difficulties our ICPs encountered in seeking to obtain timely delivery performance, and DLA agrees in principle with the objective of the recommendation. Guidance, advice, and instructions have been promulgated through various means concerning the proper course of action for supporting customer needs when a corporate contractor cannot meet normal DVD delivery requirements. However, it would be counterproductive to establish an absolute prohibition against utilizing the renegotiated corporate contract if a planned delivery time frame cannot be achieved in a specific instance. It is possible that in the future, an item may be needed which the contractor hasn't been able to supply within normal DVD delivery standards, or may not be able to furnish for the instant requirement. Ordering such an item under the revamped corporate contract, however, may still provide the most timely support available for the customer. Of course, if the longer delivery is unacceptable, then the ICP would search for item availability from surplus dealers and from various alternative means seeking a source that can meet customer needs. This may include contacts with the weapons system or higher level subassembly OEMs, surplus and reworked parts dealers, etc.

Contracting personnel have learned from experiences, customer feedback, meetings, and training since the inception of the corporate contract (December 1995), of the difficulties in securing timely deliveries from Allied. DLA and our Hardware ICPs have addressed this matter through broad agency and local procedural guidance discussing the appropriate course of action when untimely deliveries is found to be a problem. Furthermore, as detailed in the backup information following the discussion of our position concerning the audit finding, our ICPs have had continuing meetings with the contractor in efforts to overcome unsatisfactory delivery time-frames for many of the items.

In addressing this matter, DSCC advised that it already has procedures whereby the Chief of the local Corporate Contract Office notifies the appropriate contracting officer whenever a corporate contract is received in this Center. The notification includes a narrative explaining the proper utilization of the contract. Further, DSCC is entering the narrative into its internal computer system under the appropriate corporate contract, which will provide dissemination to all its acquisition associates. Education is also provided at monthly acquisition meetings held with all contracting personnel instructing on the proper use of corporate contracts. Frequently daily instructions are posted on the internal Message of the Day forum, explaining various facts relevant to specific corporate contracts. Finally, we were advised that recently DSCC instituted procedures to purchase Allied corporate contract items only through POPS for contractor direct delivery to our customers. This action was taken in anticipation of the deletion of items that cannot be furnished within an acceptable time frame.

Similar advice was received from our other Hardware ICPs. We understand that the DISC Corporate Contracting Office has instructed all users of the intent and usage of the Allied Corporate Contract. And DSCR advised they have issued policy to the workforce to ensure that long-term contracts issued by other agencies are in compliance with the Competition In Contracting Act, other statutes and will be used for their intended purposes. All corporate contracts approved for use at DSCR are listed on their Procurement Support Homepage with specific comments relating to each contract. (DISC has advised they intend to initiate a similar listing to improve the information flow to their Commodity Buying Units.) DSCR advised that comments will be added informing the workforce of the Allied corporate contract's proper usage (DVD orders not exceeding 20 days for delivery).

To summarize, all personnel at the Hardware ICPs that are involved with the corporate contractor have been made aware through various channels of this problem and appropriate course of action when encountered. Now that changes resulting from the renegotiation effort have been finalized, the advice that only those items available within our normal depot delivery time frame will be available on the contract, will be broadcast through existing local channels. Accordingly, a further letter to the Administrator, DISC, and the Commanders of the other Hardware Center is unnecessary.

**DISPOSITION:** Ongoing. ECD: September 30, 1998.

**RECOMMENDATION 8:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to establish procedures to provide Allied with reasonably accurate demand forecasting, especially for those parts not commonly used in the commercial marketplace.

**DLA COMMENTS:** Concur.

The contract contains the requirement for Demand Forecasting Conferences (DFCs) to be held at least annually, beginning within sixty days after the effective date of the contract. The requirement is a necessary element for the contractor to be able to project and have on hand, anticipated future requirements in the time frame needed. The need for satisfactory accomplishment of this requirement and for improved data has been a prime subject of discussion from contract inception and an element of the renegotiation effort.

Each of the Hardware ICPs has been sending demand information monthly to Allied and working with the company to improve the process. Some progress has been made by reaching agreement during the renegotiation on a standard set of information requested by Allied. Part of the agreement on correcting the problems on the commercial contract includes more intense and frequent interaction between Allied and DLA Item Managers. The Hardware ICPs will provide monthly raw stockage numbers to Allied, along with Reorder Point information. This will enable Allied to determine when DLA intends to start ordering from them, which will occur once the Stock on Hand is attrited down to a reasonable safety level (i.e., the Reorder Point). Allied will develop a 24 month forecast using their model which will in turn be reviewed by DLA Item Managers on a monthly basis with feedback to Allied.

Also, DLA is committing to hold quarterly forecast demand conferences with participation from our customers. The first meeting is planned for October 14-15, 1998 at DSCR.

In conclusion, the process improvements are being implemented, which obviates the need for a further memorandum to the Administrator, DISC, and to the Commanders, DSCC and DSCR.

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**DISPOSITION:** Ongoing. ECD: October 31, 1998.

**RECOMMENDATION 9:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to implement procedures to provide information on proposed contractor technology improvements to the DoD acquisition team for evaluation in order for the team to make the best value decisions.

**DLA COMMENTS:** Concur.

The IG identified (paragraph entitled "Coordinate Commercial Product Improvements," page 22 of the draft) several instances where a DLA ICP reportedly "failed to adequately coordinate commercial product improvements with the DoD acquisition team (contracting officers, item managers, users, and engineering support activities)." DoD has had programs in place for many years that address these issues, including Parts Control, Configuration Management, and Technical Data Management (see DoD Instruction 5000.2, Defense Acquisition Management Policies and Procedures). DLA plans to take the additional actions discussed below to further facilitate communications between industry and Government concerning contractor technology improvements that may be beneficial to the Government. These planned actions will apply not only to long-term contracts, but across-the-board.

Longstanding DoD policies describe the relationship between DLA ICPs and the Military Service Engineering Support Activities (ESAs). DLAI 3200.1, dated 31 October 1994, is the most recent. This fully coordinated instruction defines and specifies responsibility of the ESA as:

"The Military Service organization designated as responsible for engineering support and technical decisions for a given part or component in that Service."; and

"Preparing, maintaining, validating and approving engineering and technical data to support effective and competitive DLA procurement actions." and "Maintaining an active dialogue with the DSCs."

DLA ICPs have a responsibility for:

"Submitting to the ESA recommendations or requests for improvements in design or in specifications based on experience gained in the procurement, supply, standardization or value engineering of items managed by DLA."

DLA ICPs are thus responsible for contacting the ESA in the types of cases Allied refers to, once the contractor submits such changes. The types of changes Allied cites would have been coordinated with the End Item Program Manager (normally the ESA) since they involve life of service, additional components, and possibly performance and safety. However, we noted that the corporate contract did not contain any clause identifying requirements or procedures for contractor notification to the Government of alternate products, commercial or otherwise, that may be beneficial. Nor did the contract contain any clause, including the Value Engineering clause, incentivizing the contractor to make these submissions.

Proposed contractor technology improvements are recognized and rewarded under the Value Engineering (VE) Program. Contractors have had the option to provide proposed technology improvements to the Government. The process is by use of a Value Engineering Change Proposal (VECP). The DoD has guidance in place, under the Federal Acquisition Regulation (FAR) Part 48, and for including VECP clauses (FAR clauses 52.248-1, -2, and -3) in contracts over \$100,000. (The Defense Logistics Acquisition Directive (DLAD) 4105.1, Part 48.1 (Value Engineering) lowered the minimum threshold to \$25,000.) DLA will review this threshold and consider whether, and in what circumstances a justification may be warranted if the contracting officer decides the clauses are not needed.

When we are buying individual items, offerors are incentivized to offer alternate products, presuming they are more cost effective, because this increases their chances for award. As we increasingly put in place long-term contracts for large numbers of items, we need to ensure that these incentives are also built into these contracts. However, under FAR 48.201(a)(5), unless the chief of the contracting office authorizes its inclusion, the contracting officer shall *not* include a value engineering clause in solicitations and contracts for commercial products that do not involve packaging specifications or other special requirements or specifications.

The switch to commercial contracting is resulting in engagement with a class of manufacturers and other suppliers that have little or no previous experience in Government contracting, and especially with the procedures affecting configuration management. Therefore, it is important that the contract contain information describing the purpose, process, and incentive for passing to the Government advice and technical information concerning improvements in items under the contract that may be beneficial for Government applications. DLSC-P will send policy to the DLA ICPs to include the VECF clause in these types of procurements. Otherwise, a contractor that has already been awarded the contract may have no motivation to identify these changes to us.

In addition, we have identified a need to revise and expand use of a DLA solicitation provision used to encourage alternate offers when buying items for which the Government does not have a fully competitive technical data package available (DLAD 52.217-9002, "Conditions for Evaluation and Acceptance of Offers for Part Numbered Items"). The clause does not explicitly address offers of non-interchangeable alternate products, although many times contractors do identify such improved commercial items to buyers, and the buyers forward them for technical evaluation. We plan to expand the scope of the provision to encourage offers of alternate products that could be substituted as a different item (improved design, etc.), but are not interchangeable with the item cited in the solicitation. DLA also plans to expand use of the provision to solicitations for commercial items.

An ever-increasing number of DLA contracts will be awarded under FAR Part 12, as the agency continues to carry out the Government-wide preference for use of commercial items. Although prescriptions for provisions and clauses in other parts of the FAR are not mandatory for acquisitions conducted under Part 12, the contracting officer is responsible for determining which additional terms and conditions are needed to provide necessary coverage on topics not addressed in the Part 12 provisions and clauses. If the conditions exist that would otherwise require use of a particular provision or clause, the contracting officer is responsible for determining whether that subject needs to be addressed and for making sure appropriate terms and conditions are included in the solicitation or contract. This will be DLA's basis for requiring that long-term contracts for

commercial items include clauses providing incentives for contractors to notify the Government of product improvements in items under the contract.

To summarize, we will assure guidance on processing these suggestions is included, along with the FAR VECF clause, into the Allied corporate contract, the DSCR IQC contract, other long-term contracts, and into future contracts for commercial items, unless clearly inappropriate. In addition, we will expand use of our "alternate offers" provision, and will work with the DLA ICPs in revising DLA and local guidance. The objective is to assure the inclusion of our "alternate offers" provision and the VECF and other clauses as appropriate in solicitations and contracts, including existing and future corporate and other long-term contracts. These steps should provide sufficient incentive to encourage the identification of improved items to the Government in the future. And finally, we will track the progress and outcome of the reviews of the specific items identified by the IG.

**DISPOSITION:** Ongoing. ECD: February 28, 1999.

**RECOMMENDATION 10:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to establish a metric to monitor commercial catalog price trends in all DLA corporate contracts.

**DLA COMMENTS:** Concur.

In addressing this recommendation (paragraph entitled "Metric to Evaluate Commercial Price Increases," page 22 of the draft), the IG suggests, and we agree, that:

"The metric should measure the contractor price increases on an annual basis to ensure that increases are in line with the rate of inflation in the commercial market...";

"In addition, the metric should also measure whether the price increases are warranted based upon the past performance of the contractor...";

"If the price increases are out of line with inflation, commercial market, or past performance, then DLA needs to take corrective action to ensure that its customers get the best value for their money."; and that

"If annual commercial price increases are greater than the costs to stock the parts, DLA must reconsider procuring economic order quantities and stocking the items."

DLA is totally committed to a goal of consistently providing responsive, best value supplies and services to our customers. Objective 1.2 under DLA's Strategic Plan for accomplishing this goal specifies that we will "Meet or beat our cost and pricing commitments while seeking reduced total customer costs." Various initiatives are underway to develop metrics and automated tools to measure and track local progress across the Agency. This IG recommendation recognizes the need to measure and track progress towards this goal by major programs affecting material cost and price changes.

DLA and the Hardware ICPs have developed general as well as contract-specific analytical tools to accomplish such reviews for many years. Beginning in June 1996, we worked with the DLA Office of Operations Research and Resource Analysis (DORRA) in developing a Corporate Contract Cost Comparison (C4) Model to measure price growth for all items bought from a specific supplier of commercial and military spare parts. The model measured the contractor's catalog price increases by item over time and in comparison to prices paid to competing sources. Later the model was modified to measure price growth under DLA's initial Hardware ICP corporate contract. In February 1998, the C4 was converted to a generalized model suitable for measuring price growth under a specific corporate contract. We used the model to measure cost growth on every DLA corporate contract awarded by our Hardware ICPs to date. It flagged pricing outliers for further review by the cognizant ICPs, followed by in-depth manual analyses for extreme outliers. The program was further modified recently to support our subsequent review of all other buys made by our Hardware ICPs during FY 1996, FY 1997, and during the first three quarters of FY 1998.

Based on lessons learned, substantial refinements were incorporated into the C4 model to improve the automated assessment. The first run of the revised

prototype C4 model was accomplished on August 27. Several further refinements were incorporated and the model rerun September 11, 1998.

Individuals at various ICPs have also developed innovative models over the years. For example, DSCC conducted a test program for a specific commercial contract. If items on the contractor's price list increased beyond inflation without sufficient justification, efforts will be made to negotiate separate discounts or remove them from the contract. The intention is that in corporate contracts covering an entire price list, a sample of the items will be reviewed for excessive annual inflation. However, if the price list is received electronically, 100% analysis can easily be made. The advantage of this approach is that it facilitates automated comparative reviews of price growth when revised lists are generated.

In summary, we concur in the need to monitor changes in corporate contract prices based on changes in commercial catalog prices. We will continue to work with the ICPs to develop and refine analytical tools for measuring performance, and to develop standardized metrics, to the extent appropriate.

As a final note, we want to point out that all of our Hardware ICP corporate contracts do not provide for price changes based on catalog price increases. Some have individually negotiated prices set for specified periods or for the full performance period, regardless of whether the contractor has a commercial price catalog or list. In these instances, price changes from the preceding contract are examined as part of the normal, preaward price evaluation process. However, price trends from prior contracts are also monitored through operation of automated tools and through manual reviews.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**RECOMMENDATION 11:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to establish a metric to measure whether price increases for commercial items are warranted based upon past performance.

**DLA COMMENTS:** Concur.

Contracting personnel and managers have long recognized the need to monitor contractor conformance to contractual requirements and the underlying bases for the agreement. This need is particularly important when contracting for a new supply, service, or new type business arrangement. Close scrutiny is warranted until it is clear that satisfactory performance is being achieved and the reduced risk merits scale-back to routine, periodic rechecks. As our ICPs were shifting to corporate contracts, we reiterated this need in our June 9, 1997 memorandum to Hardware ICP Commanders, as follows:

"Do not assume use of a long-term contract is providing best value, or that you are getting what you contracted for. You need to monitor performance to assure you are getting the extra value you are paying for throughout the life of these contracts. When full value is not being realized, timely corrective actions must be taken."

As stated in comments regarding the preceding, related recommendation, DLA is totally committed to a goal of consistently providing responsive, best value supplies and services to our customers. This recommendation, like recommendation 10, is consistent with our on-going efforts to track and assure progress in this important portion (i.e., corporate contracts) of our customer support mission.

From the outset, we have supported innovation during this transition to best commercial practices. We have encouraged ICPs to develop these alternative business arrangements, with results that have generally been in the best interests of our customers. Accordingly, there are various alternative means of assuring that we are attaining the price and performance objectives we contracted for. For example, the DLA Negotiation Team sought, but was unable to negotiate and relate, a price increase metric to a performance-based metric to measure Allied's delivery performance, with remedies for unsatisfactory delivery performance (i.e., below an 85% on time fill rate). However, this is not a significant shortcoming as the contractor has been made aware that the Government will track its performance under the revised corporate contract. Allied understands that if its on-time performance is still unacceptable, DLA has the option to cancel the contract and/or to pursue a commensurate price adjustment.

The Defense Logistics Support Command (DLSC) Commander recently issued guidance to ICP Commanders and the DISC Administrator (June 8,

1998 memorandum, subject: Use of Direct Vendor Deliveries (DVDs)) as follows:

"The goal of this 'shift to commercial business practices' is to reduce costs and logistics response time (LRT), while providing access to virtual inventories and infrastructure necessary to support the war fighter during a contingency. Increased emphasis on long-term contracting, prime vendor arrangements, and corporate contracting are a few examples of initiatives designed to lead us in this direction."; and

"A good benchmark for DVD LRTs is that the delivery schedule in our long-term contracts should be no longer than the customer LRT from our DLA depots. Based on recent data, our stocked items' LRT tends to range from 15 days to 20 days based on the time DLA receives the requisition to the date the depot ships the item. This takes into account both immediate (1-3 day average LRT) and backordered shipments..."

This provides an overall standard. However, as indicated above, we are just beginning to work the issue of incorporating performance and price metrics tied to price adjustments, positive and negative incentive provisions, or other remedies to motivate effective performance. Much is to be accomplished before we will be in a position to institutionalize the results of this developmental process. In the interim, we will continue to encourage experimentation with innovative solutions on current and future corporate contracts.

We will include a discussion of these matters in a memorandum to the ICPs mentioned under comments to the preceding recommendation. However, the ICPs and contracting officers must decide which techniques are most effective in individual corporate contracts. And, we will continue to hold Hardware ICP Commanders responsible for assuring that this is accomplished.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**RECOMMENDATION 12:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to establish a metric to monitor Allied's performance on

meeting commercial item delivery times needed to provide direct vendor delivery service to its customers.

**DLA COMMENTS: Concur.**

The corporate contract will only cover 790 NSNs, all of which are sole source and all have delivery times of 15 days or less. As noted in our comments concerning the preceding recommendation, the DLA Negotiation Team was unsuccessful in efforts to negotiate a performance-based metric to measure Allied's delivery performance once revision of the corporate contract has been completed. However, Allied is aware that the ICPs will be monitoring its delivery performance (as well as price changes) and will take corrective action if performance expectations are not achieved. Since the contract is an IQC, the Government has the unilateral right not to place additional orders once the guaranteed minimum has been reached, as well as the right to not exercise the two, one-year option periods.

We note that in its discussion of this matter in the draft (paragraph entitled "Metrics to Monitor Delivery Performance," page 23 of the draft) the report suggested that:

"For comparison purposes, the metric should also measure the capability of the depots to meet these delivery requirements and whether the contractor can meet or beat the delivery times of the depots. If the contractor fails to meet the delivery requirements of its customers based upon the outcome of the metric, DLA needs to take appropriate action to ensure that those requirements can be met."

We agree with the above statement and will monitor and compare depot capability vice contract requirements and performance. We will use both current overall depot performance by each Hardware ICP for all hardware items, and past depot performance by each Hardware ICP for the specific AlliedSignal items, as points of comparison.

We have issued guidance on proper delivery times for DVDs in recent months. The DLA memorandum of June 8, 1998 (subject: Use of Direct Vendor Deliveries (DVDs)), emphasized that DLA ICPs should not engage in DVD efforts where the total of the LRT segment from initiation of the customer requisition to the recordation of receipt by the customer, is adversely affected (i.e. the LRT is greater than depot performance).

A limitation in our ability to measure and compare performance should be noted. We (both DLA and DoD) have never been fully successful in achieving full customer receipt data for DVD shipments to DoD customers around the world. For this reason we have generally opted to rely on the portion of LRT from passage of the award notice to the contractor, to the date the item is shipped. We realize this does not give us the full picture of LRT, but has still allowed us to acceptably measure and compare multiple methods of support.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**RECOMMENDATION 13:** We recommend that the Director, Defense Logistics Agency require the Commanders, Defense Supply Center Columbus, Defense Supply Center Richmond, and the Defense Industrial Supply Center to evaluate the cost recovery rates to ensure reasonableness and that separate rates are justified among centers, then charge the paperless order placement system non-stocked cost recovery rate to commercial spare parts purchased on the contract.

**DLA COMMENTS:** Concur.

DLA has always had separate rates by Center. That decision, which was made by DLA, is consistent with Activity Based Costing. It is the DLA goal that each Center's items should carry the price equal to the cost of each Center providing those items. Historically, as well as for FY 1999, DISC and DSCC have not maintained separate POPS Nonstock and POPS Stock categories. They both use a single POPS category and rate, which is their lowest, or among the lowest, CRRs, respectively. Virtually all the items coded to take the POPS rate at these ICPs are supported on a nonstocked DVD basis. Conversely, DSCR has utilized separate DVD POPS Stock and DVD POPS, both being lower than any of DSCR's other rates.

DSCR has found the need to maintain stock levels for some of the items to cover the historical level of emergency requisitions submitted by some

customers. This occurs when the contractor has not maintained sufficient safety level to enable shipment in time to cover the emergency and urgent needs of our customers, as was the case with this corporate contractor. DSCR updates the coding of POPS items annually based on a review of the

inventory on-hand, requisition priorities, contractor performance and the contractor's minimum order quantity to decide which of the two codes is more relevant to each item.

Each ICP, in conjunction with DLA Headquarters, annually establishes various CRR categories, computes a CRR for each category, and reviews the entire process for reasonableness. The review and approval process runs from April through July annually. In July we submitted our pricing tapes to DLIS. Costs are allocated to the CRR categories based on informed estimates of how much of those costs apply to an individual category. All costs of item management are included in the CRR. These costs include the costs of ICP operations, distribution depot operations, DLA Headquarters, DFAS accounting services, DRMS disposal costs, DLIS cataloging services and DISA computer services.

The ICPs review distribute the charges and allocations to CRR categories, review the reasonableness of the rate categories and resulting rates. Both DLSC and DLA review the comparative reasonableness of the categories and rates used by all DLA ICPs. The approval process involves a number of executive-level briefings at each ICP, followed by presentations at Headquarters, DLSC, and Headquarters, DLA, outlining each ICP's FY 1999 CRR categories and rates.

When we became aware of this recommendation, the CRR recomputation process for FY 1999 was virtually complete. Time did not permit accomplishment of the additional analyses we consider necessary for an informed judgment as to the propriety of adopting this recommendation and incorporating it into the CRR development process for FY 1999. However, in addition to our normal involvement in the CRR process for FY 2000, we will specifically oversee the coding for each item flagged for application of a POPS CRR vice other (noncoded) items. We will emphasize, and expect to achieve, greater consistency in the approach and results in the standard pricing of POPS items for FY 2000.

Regarding the 790 items that will continue to be covered under the corporate contract, we expect that most, if not all, will continue to be coded, or will be recoded, to Acquisition Advice Code (AAC) of H (Direct Delivery under a Central Contract (Nonstocked Items)). As such, the POPS rate(s) would be applied to requisitions for such items filled under the corporate contract.

We will ask ICPs to promptly incorporate changes to the items covered under the corporate contract upon completion of the renegotiation effort. We will also request an item-by-item report for all items bought from inception to the current date under the corporate contract plus any of the 790 remaining items that may not yet have been purchased thereunder. We will request the "before and after" AACs and other coding affecting which type CRR applies.

**DISPOSITION:** Ongoing. ECD: September 30, 1999.

**ACTION OFFICER:** Jerry C. Gilbert, DLSC-PPB

**APPROVAL:** DAVID P. KELLER, Rear Admiral, SC, USN, Commander,  
Defense Logistics Support Command

**COORDINATION:** Sharon Entsminger, DDAI, 767-6267

**DLA APPROVAL:**

A handwritten signature in black ink, appearing to read "D. P. Keller", is written over the "DLA APPROVAL:" text.

## **Audit Team Members**

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